Office of Federal Housing Enterprise Oversight
(OFHEO)

NEWS RELEASE

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OFHEO ANNOUNCES FINAL RULE FOR LOSS SEVERITY CALCULATIONS UNDER THE RISK-BASED CAPITAL REGULATION

WASHINGTON, DC — OFHEO Director James B. Lockhart announced that OFHEO has sent to the Federal Register a final rule for loss severity calculations under OFHEO's Risk-Based Capital (RBC) Regulation. The final rule corrects certain deficiencies in the formulas used to calculate risk-based capital. The changes adopted in this rule began with a notice of proposed rulemaking (NPR) published in the Federal Register on December 5, 2007. The NPR was subject to a 90 day public comment period and comments received and reviewed by OFHEO are posted on OFHEO's website. The rule becomes effective upon publication in the Federal Register.

The risk-based capital requirement is the amount of total capital – core capital plus a general allowance for loan losses less specific reserves – that an Enterprise must hold to absorb projected losses flowing from future adverse interest-rate and credit-risk conditions specified by statute, plus 30 percent mandated by statute to cover "management and operations risk." The risk-based capital standard is based on stress test results calculated for the two statutorily prescribed interest rate scenarios and changes in house prices.

With this action, OFHEO implements two changes to the existing rule. The first change is being implemented because certain loss severity equations result in the Enterprises recording profits instead of losses on foreclosed mortgages during the calculation of the risk-based capital requirement. Unaltered, the loss severity equations overestimate Enterprise recoveries for defaulted government-guaranteed and low loan-to-value (LTV) mortgages. Those results are not consistent with the Risk-Based Capital regulation and result in significant reductions to the risk-based capital requirements of the Enterprises. The second change is being implemented because the prior treatment of FHA insurance associated with single-family mortgages with an LTV below 78 percent is inconsistent with current law. The changes announced today correct these deficiencies.

Final Rule Follows.

Link to Comments Received

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OFHEO's mission is to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Office of Federal Housing Enterprise Oversight

12 CFR Part 1750

RIN 2550-AA38

Risk-Based Capital Regulation - Loss Severity Amendments

AGENCY: Office of Federal Housing Enterprise Oversight, HUD.

ACTION: Final Rule.

SUMMARY: The Office of Federal Housing Enterprise Oversight (OFHEO) is amending Appendix A to Subpart B of 12 CFR part 1750 Risk-Based Capital (Risk-Based Capital Regulation) to enhance the transparency, sensitivity to risk, and accuracy of the calculation of the risk-based capital requirement for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). OFHEO is amending the Risk-Based Capital Regulation by changing the current loss severity equations that understate losses on defaulted single-family conventional and government guaranteed loans and by changing the treatment of Federal Housing Administration insurance in the Risk-Based Capital Regulation to conform the treatment to current law.

EFFECTIVE DATE: [INSERT DATE OF PUBLICATION IN FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT: David A. Felt, Deputy General Counsel, telephone (202) 414-3750, or Jamie Schwing, Associate General Counsel, telephone (202) 414-3787 (not toll free numbers), Office of Federal Housing Enterprise Oversight, Fourth Floor, 1700 G Street, N.W., Washington, D.C. 20552. The telephone number for the Telecommunications Device for the Deaf is (800) 877-8339.

SUPPLEMENTARY INFORMATION:

Background

Title XIII of the Housing and Community Development Act of 1992, Pub.L. 102-550, titled the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Act) (12 U.S.C. 4501 et seq.), established OFHEO as an independent office within the Department of Housing and Urban Development to ensure that Fannie Mae and Freddie Mac (collectively the Enterprises) are adequately capitalized, operate safely and soundly, and comply with applicable laws, rules and regulations. The Act provides that the Director of OFHEO (Director) is authorized to make such determinations and take such actions as the Director determines necessary with respect to the issuance of regulations regarding, among other things, the required capital levels for the Enterprises.[1] The Act further provides that the Director shall issue regulations establishing the risk-based capital test (Risk-Based Capital Regulation) and that the Risk-Based Capital Regulation, subject to certain confidentiality provisions, shall be sufficiently specific to permit an individual other than the Director to apply the risk-based capital test in the same manner as the Director.[2]

[1] 12 U.S.C. 4513(a), (b)(1), (b)(3).
[2] 12 U.S.C. 1361(e)(1), (e)(3).

Pursuant to the Act, OFHEO published a final regulation setting forth a risk-based capital test which forms the basis for determining the risk-based capital requirement for each Enterprise.[3] The Risk-Based Capital Regulation has been amended to incorporate corrective and technical amendments that enhance the transparency sensitivity to risk and accuracy of the calculation of the risk-based capital requirement.[4]

Consistent with the Act and OFHEO's commitment to review, update and enhance the Risk-Based Capital Regulation in order to ensure an accurate risk sensitive and transparent calculation of the risk-based capital requirement, OFHEO published a notice of proposed rulemaking (NPRM) to incorporate amendments to the Risk-Based Capital Regulation.[5] Specifically, OFHEO proposed two changes to the Risk-Based Capital Regulation. The first change was proposed because certain loss severity equations resulted in the Enterprises recording profits instead of losses on foreclosed mortgages during the calculation of the risk-based capital requirement. The current loss severity equations overestimate Enterprise recoveries for defaulted government guaranteed and low loan-to-value loans. The results generated by the current loss severity equations are not consistent with the Risk-Based Capital Regulation and result in significant reductions in the risk-based capital requirements for the Enterprises. The second change relates to the treatment of Federal Housing Administration insurance associated with single-family loans with a loan-to-value ratio below 78%. OFHEO proposed changes related to these loans that would make the Risk-Based Capital Regulation consistent with current law.

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[3] Risk-Based Capital, 66 FR 47730 (September 13, 2001), 12 CFR part 1750.
[4] Risk-Based Capital, 66 FR 47730 (September 13, 2001), 12 CFR part 1750, as amended, 67 FR 11850 (March 15, 2002), 67 FR 19321 (April 19, 2002), 67 FR 66533 (November 1, 2002), 68 FR 7309 (February 13, 2003), 71 FR 75085 (December 14, 2006).
[5] Risk-Based Capital-Loss Severity Amendments, 72 FR 68656 (December 5, 2007).

The following table shows the estimated capital impact of all of the amendments at September 30 and December 31, 2006.

Table 1. Estimated Capital Impact of Amendments
Billions of Dollars

			RBC Requirement		
	Quarter	Interest Rate Scenario	Current Regulation	Current Regulation with Proposed Amendments	Change*
Fannie Mae	2006 3Q	Up-Rate	$22.5	$32.0	$9.5
		Down-Rate	$16.4	$25.1	$8.6
	2006 4Q	Up-Rate	$26.9	$36.6	$9.8
		Down-Rate	$9.1	$16.6	$7.5
Freddie Mac	2006 3Q	Up-Rate	$14.9	$19.4	$4.5
		Down-Rate	$13.8	$18.2	$4.4
	2006 4Q	Up-Rate	$15.3	$20.7	$5.4
		Down-Rate	$12.9	$17.5	$4.5

*Figures may not sum precisely due to rounding.

The amendments substantially increase the RBC Requirement in both the up and down interest rate scenarios for both Enterprises for the two quarters analyzed. However, if the amendments had been in effect during the analyzed periods, total capital would have exceeded the RBC Requirement and the capital classifications of the Enterprises would not have changed.

The 90-day comment period ended March 4, 2008. All comments received have been made available to the public in the OFHEO Public Reading Room and have also been posted on the OFHEO web site at http://www.OFHEO.gov.

Comments Received

Comments were received from the American Bankers Association (ABA), Fannie Mae, Freddie Mac, the National Association of Homebuilders (NAHB), and the Mortgage

Insurance Companies of America (MICA). All comments were taken into consideration. Significant comments related to the proposed regulation are discussed below.

Purpose and Scope

Fannie Mae commented that the proposed amendments fail to recognize properly its experience during times of credit stress. In support of this statement, Fannie Mae presented data on mortgage defaults that occurred between 1992 and 2006 when home prices declined more than 15% between origination and foreclosure. Within this population of loans, Fannie Mae realized a gain on 20% of the loans with an LTV of 60 percent or less and also realized a gain on six percent of the loans with high levels of third party mortgage insurance.

OFHEO does not find that the comment and data presented by Fannie Mae support a change in OFHEO's proposed amendment to the Risk-Based Capital Regulation. While gains on defaults of individual loans are possible and have occurred in the historical data, the risk-based capital stress test simulates the average behavior of groups of similar loans, rather than that of individual loans. From that perspective the data presented by Fannie Mae bolsters the OFHEO proposal to restrict negative losses. The data from Fannie Mae show that 80% of defaulted loans with an LTV below 60 percent result in a loss and 94% of defaulted loans with high levels of mortgage insurance result in a loss. Although Fannie Mae did not provide the average gain or loss for these populations, it is unlikely that there was an average gain, given the small percentages of loans with gains.

Fannie Mae also commented that the proposed amendments, by not fully recognizing the Enterprises' loss mitigation practices, do not provide the proper incentive to the Enterprises to engage in those practices. The ABA and the NAHB also raised concerns that the risk-based capital stress test might not fully recognize the benefits of the Enterprises' loss mitigation practices. OFHEO expects that only rarely, if at all, would the risk-based capital stress test limit the representation of benefits of the Enterprises' loss mitigation practices. This expectation is consistent with the data on loans with high levels of mortgage insurance that Fannie Mae presented in its comment, which showed a gain on only six percent of those loans. OFHEO also acknowledges that the risk-based capital stress test does not capture every detail of the risks and the risk mitigation strategies of the Enterprises, since, of necessity, it is a stylized representation of the financial operations and statements of the Enterprises. As such, the risk-based capital stress test reflects numerous accommodations across the dimensions of accuracy, complexity, transparency, operational workability, and regulatory caution. OFHEO will continue to review the RBC Stress Test Model and will propose enhancements where appropriate. This final amendment is a marked improvement over the prior approach.

Freddie Mac and MICA commented in favor of all of the proposed amendments. In addition to its comments on the proposed amendments, MICA raised additional concerns that were beyond the scope of the current rulemaking. MICA expressed concern that the current Risk-Based Capital Regulation allowed the cross-subsidization of interest-rate and credit risk, thereby allowing the Enterprises to hold an insufficient amount of capital against either risk. MICA also commented that OFHEO should revise the Risk-Based Capital Regulation to apply the regulation on a combined loan-to-value ratio of an Enterprise's position and to develop measures of credit risk that distinguish subprime and non-traditional mortgage structures from less-risky ones. Although these comments are beyond the scope of the current rulemaking, OFHEO nevertheless welcomes MICA's suggestions for possible future rulemaking topics.

OFHEO has taken into consideration all of the comments submitted in connection with this rulemaking, and for the reasons discussed above, OFHEO has determined to issue the amendments as proposed.

Regulatory Impacts

Executive Order 12866, Regulatory Planning and Review

The amendments incorporate changes to the loss severity equations used to calculate the risk-based capital requirement as well as changes to the treatment of Federal Housing Administration insurance in the Risk-Based Capital Regulation in order to conform to current law. The amendments to the Risk-Based Capital Regulation are not classified as an economically significant rule under Executive Order 12866 because they do not result in an annual effect on the economy of $100 million or more or a major increase in costs or prices for consumers, individual industries, Federal, state or local government agencies, or geographic regions; or have significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in foreign or domestic markets. Accordingly, no regulatory impact assessment is required. Nevertheless, the amendments were submitted to the Office of Management and Budget (OMB) for review under the provisions of Executive Order 12866 as a significant regulatory action.

Executive Order 13132, Federalism

Executive Order 13132 requires that Executive departments and agencies identify regulatory actions that have significant federalism implications. A regulation has federalism implications if it has substantial direct effects on the states, on the relationship or distribution of power between the Federal Government and the states, or the distribution of power and responsibilities among various levels of government. The Enterprises are federally chartered entities supervised by OFHEO. The amendments to the Risk-Based Capital Regulation address matters which the Enterprises must comply with for Federal regulatory purposes. The amendments to the Risk-Based Capital Regulation address matters regarding the risk-based capital calculation for the Enterprises and therefore do not affect in any manner the powers and authorities of any state with respect to the Enterprises or alter the distribution of power and responsibilities between Federal and state levels of government. Therefore OFHEO has determined that the amendments to the Risk-Based Capital Regulation have no federalism implications that warrant preparation of a Federalism Assessment in accordance with Executive Order 13132.

Paperwork Reduction Act

The amendments do not contain any information collection requirements that require the approval of OMB under the Paperwork Reduction Act (44 U.S.C. 3501 et seq.).

Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601 et seq.) requires that a regulation that has a significant economic impact on a substantial number of small entities, small businesses, or small organizations must include an initial regulatory flexibility analysis describing the regulation's impact on small entities. Such an analysis need not be undertaken if the agency has certified that the regulation does not have a significant economic impact on a substantial number of small entities 5 U.S.C. 605(b). OFHEO has considered the impact of the amendments to the Risk-Based Capital Regulation under the Regulatory Flexibility Act. The General Counsel of OFHEO certifies that the amendments to the Risk-Based Capital Regulation are not likely to have a significant impact on a substantial number of small business entities because the regulation is applicable only to the Enterprises, which are not small entities for the purposes of the Regulatory Flexibility Act.

List of Subjects in 12 CFR Part 1750

Capital classification, Mortgages, Risk-based capital.

Accordingly, for the reasons stated in the preamble, OFHEO is amending 12 CFR part 1750 as follows:

PART 1750 — CAPITAL

1. The authority citation for part 1750 continues to read as follows:

Authority: 12 U.S.C. 4513, 4514, 4611, 4612, 4614, 4618.

2. Amend Appendix A to subpart B of part 1750 as follows:

a. In paragraph 3.6.3.6.4.3[a]1, under the explanation "Where: m' = m, except for counterparties rated below BBB, where m' = 120", add to the right side of the equation "and the loan group comprises conventional loans";

b.I n paragraph 3.6.3.6.5.1[a] revise equation;

c. In paragraph 3.6.3.6.5.1[b]2 revise equation.

Appendix A to subpart B of part 1750-Risk-Based Capital Text Methodology and Specifications

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3.6.3.6.4.3 * * *

[a] * * *

1. * * *

where:

m' = m, except for counterparties rated below BBB, where m' = 120

$MIExp_m^{LG} = 1 \, if \left(\left(LTV_{ORIG} \times \frac{UPB_m^{LG}}{UPB_{ORIG}^{LG}} \right) < 0.78 \right)$ and the loan group comprises conventional loans

$MIExp_m^{LG} = 0$ otherwise

0.78 (78%) = the LTV at which MI is cancelled if payments are current

* * * * *

3.6.3.6.5.1 * * *

[a] * * *

$$LS_m^{SF} = MAX\left[\left(\frac{1}{\left(1+\frac{DR_m}{2}\right)^{\frac{MQ}{6}}} + \frac{\left(\frac{MQ}{12} \times PTR_m\right) + F - MI_m}{\left(1+\frac{DR_m}{2}\right)^{\frac{MF}{6}}} + \frac{R - RP_m - ALCE_m}{\left(1+\frac{DR_m}{2}\right)^{\frac{MF+MR}{6}}} \right), 0 \right]$$

[b] * * *

2. * * *

$$LS_m^{VA} = \max\left[\frac{1+F+\left(\frac{MQ}{12}\times PTR_m\right)+\left(R-RP_m\right)-0.30}{\left(1+\frac{DR_m}{2}\right)^{\frac{MF}{6}}},0\right]$$

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Dated: 6/10/08

Signature James B. Lockhart III
James B. Lockhart III
Director, Office of Federal Housing Enterprise Oversight.