



HOUSING & FINANCE POLICY

DAVID A. CROWE, PH.D.
Senior Staff Vice President

January 16, 2002

Mr. Alfred Pollard
General Counsel
Office of the General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, NW, Fourth Floor
Washington, DC 20552

Re: Proposed Amendments to Final Risk-Based
Capital Regulation (RIN 2550-AA23)

Dear Mr. Pollard:

On behalf of the 205,000 members of the National Association of Home Builders (NAHB), I appreciate the opportunity to comment on the Office of Federal Housing Enterprise Oversight's (OFHEO) proposed amendments to the final risk-based capital rule (the Final Rule) for Fannie Mae and Freddie Mac (collectively, the Enterprises).

NAHB supports the risk-based capital (RBC) requirement for the Enterprises. We commend OFHEO for its efforts to develop the innovative and dynamic RBC standard mandated by the Federal Housing Enterprises Safety and Soundness Act, culminating in the publication of the Final Rule on September 13, 2001. As we have previously commented, NAHB's overriding concern in the development of the Final Rule is to ensure that the RBC standard accurately calibrates to the Enterprises' risks in order to avoid any unintended adverse consequences for the cost and availability of housing credit.

The Final Rule, as published, would have several adverse and, we believe, unintended consequences for the housing sector, especially for those currently underserved by the mortgage market. NAHB believes that the modifications to provisions of the RBC stress test relating to non-derivative counterparty haircuts and multifamily loans announced on December 11, 2001 (the December Proposal) will help to mitigate potential negative impacts on the housing market. NAHB applauds OFHEO for working with the Enterprises and the industry to propose these revisions prior to implementation of the Final Rule. Nevertheless, as discussed below, we believe that further adjustments to these provisions are warranted. We will confine our comments to the impact of the December Proposal for mortgage insurance and multifamily housing.

Implications for Mortgage Insurance

OFHEO is proposing several changes to the provisions for non-derivative counterparty haircuts that would affect the amount of capital the Enterprises must hold against mortgages backed by mortgage insurance. Specifically, OFHEO proposes to modify provisions for non-derivative counterparty haircuts by:

- Incorporating loss severity into haircut calculations by multiplying default rates by loss severity rates;
- Establishing 70 percent loss severity rate (or a 30 percent recovery rate);
- Lowering default rate for AA-rated counterparties from 15 to 12.5 percent;
- Extending the phase-in period for counterparty haircuts from five to ten years.

The net effect of these changes will be to reduce the haircut for AAA-rated mortgage insurance (MI) companies from the 5 percent specified in the Final Rule to 3.5 percent. The capital haircut for AA-rated MIs will be reduced from 15 to 8.75 percent. As a result the haircut differential or the spread between AA- and AAA-rated MIs will be narrowed from 10 to 5.25 percentage points.

NAHB supports the lengthening of the phase-in period and the incorporation of severity rates into the haircut calculation. The reduction of the haircut differential between AAA and AA MI companies is also a positive step, but we believe that the differential in haircuts should be eliminated.

Any differential in the capital haircuts for AAA- and AA-rated mortgage insurance is unwarranted and could result in higher mortgage costs, especially for affordable housing loans. Mortgage insurance is an important factor in the expansion of homeownership opportunities. Low- and moderate-income mortgage borrowers typically will have insufficient savings to make more than a 20 percent downpayment, and therefore will require mortgage insurance to obtain a loan. Thus, the cost of private mortgage insurance is a very real issue for low- and moderate-income families.

At present, there are eight mortgage insurance companies. Of these, only two are rated AAA, the remaining six are rated AA. NAHB is very concerned that by imposing such a stringent capital haircut on mortgage insurance provided by AA-rated mortgage insurers to the GSEs, OFHEO's Final RBC Standard creates a de-facto AAA standard for mortgage insurers. We believe this de-facto standard will arise because mortgages insured by AA-rated providers will require greater capital support by the GSEs, and hence will be less profitable to the GSEs, a situation that will provide the GSEs with a strong incentive to concentrate their mortgage insurance business with the two AAA-

rated providers. Such a concentration could very well cause the price of mortgage insurance to increase and/or underwriting requirements to become more stringent. In addition, such a concentration could stifle the creativity and innovation among the mortgage insurance providers to devise new and better ways to assist low- and moderate-income families in achieving homeownership. This in turn could jeopardize the ability of the GSEs to meet the ambitious affordable housing goals established by HUD.

Further, the differential in capital treatment for AAA- and AA-rated counterparties is inconsistent with the approach of U.S. and international banking regulators. Neither the federal banking regulators, nor the international banking regulators require a capital differential between AAA- and AA-rated counterparties. Counterparties, including mortgage insurers, rated AA or better are treated equally under the risk-based capital rules for domestic depository institutions, as well as in the draft Basel Accords setting international bank capital standards. This equivalent treatment of AA- and AAA-rated counterparties was demonstrated most recently in the final capital standards for recourse, direct credit substitutes and residual interests adopted by the federal bank and thrift regulators late last year.

Multifamily Issues

Fannie Mae and Freddie Mac are the dominant providers of multifamily financing. Thus, it is extremely important that OFHEO's RBC model accurately measure the risks of multifamily lending to avoid unintended adverse changes in the multifamily market. NAHB believes that the Final Rule miscalibrates multifamily risk and results in excessive capital requirements for multifamily loans that could discourage the GSEs from engaging in multifamily business, thereby making it difficult for multifamily builders to finance such projects. This is true for all multifamily loans, but especially for adjustable-rate mortgages (ARMs), small projects and rural multifamily housing. The negative effects of the Final Rule on the multifamily market are in direct contrast to the incentives HUD has provided in the affordable housing goals for the GSEs to increase their service to the multifamily market.

OFHEO's December 2001 proposal makes several improvements to the measurement of multifamily risk, specifically:

- Reduction of the BBB (unrated) lender haircut from 40 to 28 percent and increase in phase-in period from 5 to 10 years;
- Respecification of the assumptions underlying the multifamily default equation which has reduced the volatility of capital over the life of the loan;
- Decrease in loss severity assumption from 55 to 44 percent;

- Modification to Final Rule to provide for no prepayments in the down-rate scenario inside prepayment penalty or yield maintenance period; and,
- Changes to ARM variables that reduce the cumulative default rates for ARM loans in the up-rate scenario from 95 percent to about 40 percent.

NAHB believes that the combined effect of the proposed changes will be a better calibration of capital and multifamily risks. These changes are positive steps that will help to mitigate disruption in the multifamily market, but we believe that further adjustments are necessary.

Haircut for DUS Lenders

NAHB is pleased that OFHEO has reduced the capital haircut for the Fannie Mae Delegated Underwriting and Servicing (DUS) Program. The Final Rule would treat unrated DUS seller/servicers as BBB counterparties, requiring a 40 percent capital haircut. The December Proposal reduces the haircut for BBB-rated counterparties to 28 percent, due to the incorporation of a 70 percent loss severity rate. OFHEO has proposed to permit a higher rating than BBB for Fannie Mae DUS lenders, up to AA, if the lender is collateralized by a fully funded reserve account that is equal to or greater than one percent of the aggregate balance covered by the loss sharing agreement.

NAHB views these as positive changes, but is concerned that the amended proposal continues to disadvantage the Fannie Mae DUS risk-sharing model vis a vis the Freddie Mac business model in which lenders have no delegated authority. We believe there is value in the marketplace of two competing multifamily business models and that the OFHEO RBC rule should not favor one over the other.

Furthermore, the amended proposal fails to take into account the value of the servicing stream held by DUS lenders. Fannie Mae can immediately capture this servicing if lenders fail to perform on their loss sharing obligation. We believe there should be some recognition of the value of the DUS servicing assets in the model.

Treatment of ARMs and Small Loans

NAHB is concerned that the December 2001 Proposal does not fully alleviate concerns with the treatment of multifamily ARM loans. The proposed amended rule retains the impact of a separate "ARM Flag" in projected defaults, which assumes that ARM borrowers are more likely to default than fixed-rate borrowers, even if interest rates do not increase. This results in assumed cumulative default rates for ARMs in the 40 to 45 percent range, compared to 10-15 percent default rate for fixed-rate mortgages (FRMs). While ARMs will present greater risk than FRMs in a rising rate environment,

the magnitude of the difference between ARM and FRM default rates in OFHEO's model is significantly greater than we believe is warranted by the underlying economics. Multifamily borrowers do not necessarily select ARM loans over fixed-rate because of lower payment capacity, but because of the financing needs of the project. Further, the assumption recognizes no distinction between conservatively underwritten ARM loans and those with more aggressive underwriting. Such stringent capital treatment for multifamily ARM loans could reduce secondary market support for this product, which is often used by banks and thrifts to finance small multifamily projects. NAHB urges OFHEO to revisit the relationship between ARMs and FRMs as more data and information become available. We also encourage OFHEO to work with the Enterprises to incorporate payment caps or other forms of payment protection into the RBC model.

FRMs Without Updated Ratios

Also of concern to NAHB is a new provision contained in the amendment increasing annual default rates by 20 percent on FRM loans without updated debt service coverage ratios. This appears to derive from an assumption that a lack of property operating information for a certain year automatically means that a loan is riskier than another loan where operating information is available. We disagree with this assumption, particularly when both loans were originated using the same underwriting guidelines. This provision should be dropped.

Conclusion

NAHB strongly supports a well-designed and implemented risk-based capital standard for Fannie Mae and Freddie Mac. We commend OFHEO for its willingness to amend the RBC rule to improve calibration of the Enterprises' risk and capital in order to avoid unintended adverse consequences for the cost and availability of housing credit. NAHB believes that the modifications to the RBC stress test contained in the December 2001 Proposal will help to mitigate potential harmful effects of the RBC rule. The net effect of the proposed changes will be to reduce capital requirements for the Enterprises' risk-sharing arrangements and multifamily activities. The stringent haircut and multifamily provisions contained in the Final Rule would have discouraged the Enterprises from engaging in risk reducing strategies with private mortgage insurers, as well as multifamily lenders and builders participating in risk-sharing arrangements. The result ultimately could have been higher housing costs, especially in the affordable housing area.

The proposed changes to the counterparty haircut and multifamily provisions are positive steps toward alleviating these concerns, but we believe further adjustments are needed. Specifically, NAHB recommends:

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- Elimination of the differential in the capital haircuts for AAA- and AA-rated mortgage insurance;
- Recognition of the servicing stream held by Fannie Mae DUS lenders;
- Better calibration of multifamily ARM and FRM default rates by incorporating ARM payment caps into the multifamily default model; and,
- Dropping the new provision that would increase default rates on fixed-rate multifamily loans without updated debt service coverage ratios.

Sincerely,

Dave Crowe

David A. Crowe, Ph.D.
Senior Staff Vice President
Housing and Finance Policy