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April 14, 2000

Mr. Alfred Pollard
General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, NW, 4th Floor
Washington DC 20552

Re: Reply to Comments filed on Proposed Rulemaking on Risk-Based Capital, RIN 2550-AA02

Dear Mr. Pollard:

Fannie Mae appreciates the opportunity to provide further analysis of this rulemaking, based on the comments filed to date.

Fannie Mae continues to believe that OFHEO should move quickly to complete a final risk-based capital standard while assuring that the final rule meets the three tests of operational workability, accommodating innovation, and tying capital to true economic risk. We particularly wish to repeat our conclusion that with the modest operational changes recommended by Fannie Mae, OFHEO "could begin using its test in a shorter time frame than otherwise would be possible given the tremendous operational complexity embedded in NPR 2."

General Consensus Supports Needed Changes

Fannie Mae has reviewed the total of 60 comments received as of April 13. We are encouraged that the substantive comments reflect an emerging consensus supporting the need for speedy resolution of the issues. A clear consensus also has emerged supporting the three principles above, as well as general agreement on some remedies for technical issues outlined in our comment and that of Freddie Mac. These comments represent a broad spectrum of interests including Wall Street, former regulators, trade associations representing the housing industry, and organizations that work to ensure affordable housing. While the comments vary in the specificity of their recommendations, a clear consensus supports revising the model to:

- improve operational workability, including requiring Fannie Mae and Freddie Mac (the Companies) to run the stress test model and report results subject to OFHEO verification;
- accommodate flexibility and innovation;

- reduce the “haircuts” applied to risk sharing;
- eliminate the penalty on low downpayment loans;
- simplify and eliminate distortions within the multifamily model;
- ensure that the regulation avoids deterring GSE market support during economic downturns;
- improve the prepayment and default calibrations;
- improve the refunding assumption;
- avoid misspecifications that could impair the utility of low-income housing tax credits and mortgage revenue bonds; and
- modify the approach for estimating non-Treasury spreads.

Among the most thoughtful comments are those of former Comptroller of the Currency, Eugene Ludwig. In his view, OFHEO could best achieve the three goals by relying more heavily on individual models. He also notes his high regard for OFHEO’s examination capacity to support such an approach:

> [T]he approach proposed by OFHEO...needlessly restricts the ability of OFHEO’s examiners to utilize their experience and judgment in evaluating the regulated entities’ risk measurement and risk management practices. I believe OFHEO has a highly capable staff of examiners—including some who previously served in the agency I formerly headed—and I believe the statutory objectives can be better achieved by relying on their ongoing and individualized supervision of the manner in which each enterprise individually implements a model that conforms to the statutory requirements....Similarly, with examiners who are well-equipped to evaluate these two entities, there is no need for OFHEO to tie its examiners’ hands by imposing a fixed, standardized model for measuring risk.

Although Fannie Mae continues to support the use of OFHEO’s model, Mr. Ludwig’s observations lend strong support to our recommendations on changes to permit operational workability and accommodation of innovation.

Beyond the summary provided above, we do not believe it would be useful to describe each of the responses that support Fannie Mae’s March 10 comment. It is worth noting, however, that the majority of commenters support an effective final rule that is operationally workable, accommodates innovation, and ties capital to true economic risk.

<u>Minority Views</u>

Fannie Mae identifies below a series of comments offered by a small minority of eleven respondents, some related to technical issues and others related to matters of policy. Not every comment noted was made by each of the eleven. However, these comments merit close

attention because although they purport to promote workability, innovation, and tying capital to risk, they would in practice achieve just the opposite.

Minority Views on Stringency of OFHEO's Model

Two commenters assert that the risk-based capital standard embedded in the proposed regulation is not as stringent as that required for banks and thrifts. As support, one respondent cites a comparison of required capital under the OTS standards for Fannie Mae, Freddie Mac, and Washington Mutual (WAMU) that is both inappropriate and one-sided.

The proposed risk-based capital standard for Fannie Mae and Freddie Mac is based upon a stress-test approach for determining required risk-based capital. The OTS standards are predominantly ratio-based. Fannie Mae believes, as it notes in its March 10 comment letter, that a stress-test approach is superior to a ratio-based approach for ensuring safety and soundness. A stress test is forward-looking, adjusts to changing market conditions, and quantifies all major risks. Ratios, on the other hand, are static, point-in-time measures and do not capture all relevant risks of a financial institution. Indeed, current thrift and bank regulatory risk-based minimums derive from arbitrary formulas using very limited credit-risk categories. Bank supervisors agree that the current risk-based framework needs to change.

Based upon analysis done by IPS Sendero and First Manhattan Consulting Group, the typical bank or thrift that is deemed to be well-capitalized, as WAMU is in the example cited, would need 60-75 percent more capital in order to survive the rigors of a stress test comparable to that specified in the proposed risk-based capital regulation. As Fannie Mae notes in its March 10 comment to OFHEO, banks and thrifts are subject to federally established capital minimums using both a leverage ratio (capital as a percent of non-risk weighted assets) and a "risk-based" ratio (capital as a percent of risk-weighted assets). However, bank capital requirements are not based upon the quantification of risk under protracted stressful interest-rate and credit conditions.

Another commenter notes that the rating agency tests that are applied to mortgage insurers (MIs) are more severe than the OFHEO stress test. Because the S&P and OFHEO tests handle seasoning differently, a direct comparison of seasoned books is inappropriate. By contrast, for unseasoned loans, a more direct comparison can be made between the S&P standard and the OFHEO down-rate scenario, because both are based on economic recessions characterized by declining interest rates.

In the OFHEO model, conditional prepayment and gross loss severity rates are much higher than those stipulated by S&P. Further, conditional default rates also tend to be higher in the OFHEO model. For the entire stress period, however, S&P might show more aggregate defaults due to the fact that its prepayments are much slower. The net effect on cash flows and required

capital will depend upon whether the sum of reduced earned premium income in the OFHEO construct is greater than the impact on capital of higher defaults in the S&P test.

A key factor in determining stringency is loss severity. Fannie Mae and Freddie Mac typically face loss exposure after primary mortgage insurance, so the higher gross loss severity rates in the OFHEO model, combined with the more rapid prepayments versus the S&P test, make the net cash flows in the OFHEO test more stringent than those required for S&P's AA rating. For a mortgage insurer in the first loss position, the S&P test, which specifies higher foreclosure costs than the OFHEO model, will yield higher loss severities. As a consequence, for mortgage insurers the level of initial capital required to pass the OFHEO stress test appears slightly less than that required for the S&P AA standard when applied against newly originated mortgages.

However, the OFHEO risk-based capital requirement is 130 percent of the capital required to pass the stress test because of a capital surcharge, mandated by statute, to reflect management and operations risk. An equivalent management and operations surcharge is absent from the S&P standard. With its inclusion, the OFHEO risk-based capital requirement is **more stringent** than that required for an S&P AA rating when applied to either mortgage insurers or Fannie Mae and Freddie Mac.

Minority Views on Innovation and Workability

A few of the minority commenters make recommendations that would further impair innovation and workability. These include suggestions that "…all interested parties be included in any review of new products, programs, or credit enhancements not addressed by the proposed regulation;" that OFHEO implement capital changes without comment or review if the effect of the change on required capital were 10 percent or less; and that OFHEO provide for routine updating of the model to reflect a changing mortgage market. Each of these recommendations has serious flaws.

A process that invites wide-ranging public participation in the estimation of required capital for new products and activities will be massively cumbersome and invasive. Transparency requires only that all interested parties understand how OFHEO arrives at its determination of required capital. Innovation will be stymied if Fannie Mae and Freddie Mac must share confidential business plans for the purpose of determining required capital in this manner.

To improve the flexibility and responsiveness of the proposed model, our March 10 comment suggests that OFHEO could implement a process that directs Fannie Mae and Freddie Mac to determine the interim treatment for products and activities not recognized in the final regulation. Each company would, of course, be required to reasonably apply, adapt, or combine the regulation's approaches, historical information, and industry best practice, all subject to OFHEO's full review and acceptance. A process by which the Companies must wait before innovating for their regulator to make a judgment on required capital is seriously flawed.

Allowing the regulator to implement capital changes of up to 10 percent without comment or review would only worsen the problem while further impairing workability, since the Companies would have even less of an ability to anticipate the capital treatment of the business they execute.

With respect to the issue of routine updating of the model, OFHEO does indeed have the ability to amend the final regulation to change the stress test. However, routine updating would be extremely counterproductive: it would directly undercut the stability that is critical for the rule to be operationally workable, and for the Companies to engage in capital planning. The concept of stability also is central to OFHEO's statutory mandate to establish a risk-based capital rule that is transparent, as noted in our March 10 comment; frequent changes to the rule would reduce transparency. Finally, routine updating of the model should not be necessary because additional observations about mortgage performance in normal times provide little, if any, new information that would justify a re-estimation of a worst-case stress scenario. For these reasons, we wish to repeat our strong recommendation that OFHEO adopt in its final rule a "standstill" period during which no changes will be made to the final regulation.

One commenter notes that OFHEO would be "well-advised" to appoint a "technical advisory board" for matters related to NPR 2 and the model. As a legal and policy matter, OFHEO will receive all necessary "technical advice" through the public comments that it receives on its notices of rulemaking on the risk-based capital standard.

<u>Minority Views on Tying Capital to Risk</u>

A number of the minority commenters offer technical recommendations that serve to weaken rather then strengthen the link between required capital and risk. Most of these relate primarily to credit enhancements and counterparty risk and single-family mortgage performance. We discuss several of these comments below.

Credit Enhancements and Counterparty Risk

Seven commenters that address credit enhancements and counterparty risk do not appear to have an improved tie between capital and risk as a primary objective. Rather, their recommendations, if implemented, would maintain or increase the mortgage industry's volume of new insurance regardless of the cost to the homeowner or the mortgage finance system, as noted below.

<u>*Haircut on Credit Derivatives Should Be 100 Percent*</u>

This would eliminate all forms of credit enhancement aside from primary mortgage insurance, an attempt to discourage competition and limit the Companies' ability to innovate in order to diversify our risk. There are numerous forms of risk-transfer arrangements that are at least as safe as the contingent obligation of an ongoing business, such as that of a monoline mortgage

insurer. For example, derivative transactions that are collateralized credit-linked securities or risk-transfers with well-capitalized firms with diversified books-of-business can reduce overall risk exposure. Indeed, a derivative counterparty may be more able to absorb losses than mortgage insurers. The risk-based capital rule should accommodate innovation and promote alternative forms of safe and cost-efficient risk management techniques. This will, in turn, allow the homebuyer continued access to mortgage products at the lowest price possible.

Mortgage Insurers Should Receive Lower Credit Risk Haircuts Than Other Insurance Providers

This proposal would stifle innovation and competition rather than creating a closer link between required capital for the Companies and their risk. A monoline mortgage insurer may have no greater capacity to make good on its insurance obligations than a similarly rated entity that does not provide primary mortgage insurance. Fannie Mae might well be able to reduce its overall risk exposure by seeking credit enhancement with a variety of counterparties whose performance is not correlated one to the other, rather than concentrating its insurance with counterparties whose performances are highly correlated, such as monoline mortgage insurers. Although a rating may accurately measure the risk of a single entity defaulting, it fails to capture the systemic risk to Fannie Mae and the mortgage system of multiple insurance providers failing. The latter is a combination of the individual risk of each counterparty and how these risks all interact together.

Haircut on BBB and Unrated Counterparties Should Be 100 Percent

As noted in our comment letter, OFHEO’s proposed haircut of 80 percent for BBB-rated entities is extremely excessive, by several orders of magnitude, relative to past experience, including that of the Great Depression. Thus, a suggestion to increase that haircut to 100 percent cannot be supported by any reasonable analytical perspective. Furthermore, we believe it is appropriate to aggregate non-rated entities with BBB-rated counterparties for the purpose of assessing an appropriate haircut. Fannie Mae believes that a careful and thorough analysis of counterparty risk exposure requires a detailed examination of the specific institution offering the credit enhancement and a review of the contractual agreements that define this exposure. Many counterparties are unrated; this is particularly true of participants in the multifamily DUS program, a vital tool for ensuring access to affordable rental properties. However, Fannie Mae’s business practices ensure that investment grade quality credit enhancement, at a minimum, is achieved through contractual requirements regarding minimum capital, liquidity, loan loss reserves, and underwriting/servicing standards. Additionally, as we noted in our March 10 comment, recovery values based upon contractual agreements need to be explicitly recognized by OFHEO in the final regulation. With respect to multifamily DUS lenders, for example, Fannie Mae is legally entitled to DUS servicing income and lender reserves.

Fannie Mae's Flex 97 Product Results in Higher Mortgage Costs

Flex 97 lowers both the cost of homeownership and the risk to Fannie Mae by utilizing a more efficient structure of credit enhancement. The combination of reduced primary mortgage insurance supplemented by pool policies from highly rated issuers allows borrowers more affordable access to mortgage credit. Our partners in the mortgage insurance industry still play a critical role in our ability to mitigate risk. However, the innovative substitution of a one-time delivery fee in place of more expensive monthly insurance premiums brings incremental value and access to borrowers who might otherwise not be able to purchase a home.

Single-family Mortgage Performance

A few comments and suggestions that address technical specifications related to single-family mortgage performance would serve to further widen the gap between required capital and risk.

Cumulative Default Rates Fall Short of Benchmark Loss Experience in the Down-Rate Environment

The direction of the proposed regulation's result with respect to cumulative default rates after the imposition of down-rate interest rate stress and prepayments is reasonable and analytically consistent. The decline in interest rates in the down-rate scenario is larger and more rapid than the decline witnessed in the benchmark experience. Consequently, prepayments in the down-rate scenario are more rapid than in the benchmark experience. Faster prepayments reduce the level of outstanding balances at risk. Hence, even though periodic conditional default rates may exceed those of the benchmark, realized defaults and losses can fall below the benchmark loss experience.

OFHEO's model is calibrated so that cumulative defaults match the actual benchmark experience given the same loan profile, interest rates, and home price path. No empirical or theoretical basis exists for calibrating the model to the down-rate stress path.

We advocate in our March 10 comment letter that prepayments also should be calibrated to the benchmark experience, which would lower the speeds proposed by OFHEO in the down-rate scenario. However, because interest rates decline in the stress period by more than the benchmark experience, prepayments in the down-rate stress test would still be somewhat faster than the benchmark period. Thus, stress period defaults would still be somewhat lower than benchmark period defaults.

As we discussed in response to NPR 2, Fannie Mae believes the cumulative default rate used in the benchmark calibration is overstated. This overstatement is attributable to three factors. First, loans were misclassified in the provisional data set used to calculate default rates in NPR 1. Second, termination data for cash loans in the early part of the benchmark period (i.e., 1984-

1986), when defaults should be expected to be considerably lower, is not available. Third, the NPR 1 data does not include MBS performance because the data does not allow a distinction between defaults and voluntary prepayments on MBS loans from the benchmark period. During this period, Freddie Mac's experience was that MBS loans defaulted at lower rates than cash loans. Fannie Mae estimates that this total overstatement is at least 4 percentage points. Fannie Mae welcomes the opportunity to work with OFHEO to reconcile this difference so the final rule can be calibrated to the proper benchmark loss experience.

Default Rates are Understated for Seasoned Loans

This claim is difficult to evaluate because the research supporting it is based upon proprietary data of the commenter, a data set that is said to be "substantially larger" than Fannie Mae's and Freddie Mac's combined experience. To the extent that the data supporting the analysis represent the performance of non-Fannie Mae and non-Freddie Mac experience, the results are not likely to be applicable to Fannie Mae and Freddie Mac business. Mortgages that are not Fannie Mae/Freddie Mac-eligible because they exceed the conforming loan limit or fail to meet Fannie Mae's or Freddie Mac's underwriting guidelines are likely to perform substantially differently than eligible mortgages.

More generally, the proposed regulation's default model has been estimated over a broad range of seasoned and unseasoned loans from both Fannie Mae and Freddie Mac. Therefore, the model should capture the relative performance of both types of loans for the Companies.

Further Disaggregation Should Be Required for LTVs Above 90 Percent

High-LTV lending is treated quite punitively by the proposed regulation, which requires capital for these loans well in excess of their inherent economic risk. It is important that OFHEO implement the modifications suggested by Fannie Mae and Freddie Mac in our respective comment letters to correct this situation. There is overwhelming support for this amongst those who provided comments to OFHEO on the proposed regulation. Once this is done, the issue of further disaggregation could be entertained. However, when assessing capital specific to the highest LTV levels, OFHEO must recognize company business practices and credit controls—such as risk-sharing, automated underwriting, and the use of borrower credit information—that further enhance the credit quality of high LTV loans.

Improper Specification of Home Price Index Increases Procyclicality

Several respondents note that the home price index as specified increases the procyclical nature of the proposed regulation. Indeed the proposed regulation is procyclical, as others and we have pointed out—the amount of required capital increases disproportionately in response to a decline in the economic cycle. This does have the potential to exacerbate housing downturns because it may limit the Companies' ability to support mortgage markets when most needed.

Unquestionably, the proposed regulation needs to maintain a close link between risk and required capital. Fannie Mae supports the view that, in general, required capital should be high when economic risks are high. At the same time, the proposed regulation must not unnecessarily preclude Fannie Mae's vital role of providing mortgage market liquidity in times of stress. One possible method of addressing these two goals might be to use a moving average of historical home prices for purposes of determining the Companies' current LTV profile. This could serve to dampen the capital impact of rapid home price movements while still relating capital to broad-based and long-term risk.

Home Price Decline is Understated During the Stress Period

A few commenters assert that the home price decline during the stress period is understated because of a belief that the OFHEO home price index is not estimated on a data set that includes the sales price of defaulted loans. These commenters are factually incorrect. The transactions data provided to OFHEO by Fannie Mae and Freddie Mac do include defaulted loans among the transaction records.

These commenters also note that the home price experience used by OFHEO is not stringent enough because it fails to match the benchmark experience. OFHEO used the ten-year sequence of appreciation rates from the West South Central Census Division, beginning in 1984. While not exactly matching the ALMO experience, it is very similar and does not create a perceptible bias.

One respondent suggests substituting the regional home price path used by Moody's in its AAA stress test. Use of this price path not only would represent a large departure from the benchmark experience and the current model calibration, but also would result in a risk-based capital standard well above an AAA threshold, given its many other stringent features (e.g., high loss severity rates, counterparty haircuts, no benefit for national diversification, interest rate shocks outside historical experience, and a management and operations capital premium of 30 percent).

Prepayment Speeds Are Too High in the Up-Rate Scenario

One respondent opines that prepayment speeds in the up-rate scenario are too fast, based on comparisons to the benchmark experience. As noted in Fannie Mae's comment letter, prepayment speeds are, in fact, too slow in the up-rate environment for two primary reasons.

First, most mortgages outstanding in the early 1980s were assumable or contained due-on-sale clauses that were not enforced. Thus, historical prepayment rates are understated compared to those that would be expected today in a stressful up-rate environment. Second, OFHEO's up-rate prepayment estimates are the result of model extrapolations estimated primarily in a down-

rate environment, which make them unreliable for the up-rate scenario. Industry surveys and external studies on homeowner mobility suggest that prepayment speeds as currently specified in the up-rate environment are too slow by as much as 3 to 4 percentage points on an annualized basis.

Prepayment Speeds Are Too Slow in the Down-Rate Scenario

Two respondents note that prepayment speeds in the down-rate scenario are too slow. They assert that changes in technology and business practices among originators have removed much of the friction and reduced much of the cost associated with prepaying a loan. While recent industry trends have reduced many of the frictions associated with the loan origination process, two factors serve to lessen these effects.

First, origination costs, while reduced, remain a significant impediment to frictionless prepayment in response to interest rate incentives. Second, the stress test is a period characterized by significantly harsh economic and credit events. Such widespread credit stress notably dampens mortgagors' response to large interest rate declines, as borrowers who would like to refinance are unable to qualify for refinancing because of reduced equity or personal credit reasons. Increasing prepayment speeds in the down-rate scenario would only exacerbate the fact that speeds have not been calibrated to the benchmark experience.

Operating Expenses Should Not Decline During the Stress Period

A few respondents suggest that operating expenses during the stress period should not decline because there will be higher REO and loss management costs. As Fannie Mae notes in its March 10 comment letter, well under half of Fannie Mae's cost structure is currently devoted to the maintenance and support of existing book-of-business balances. The remainder is devoted to the development and marketing of new products and operating techniques. Thus, Fannie Mae recommends a sizable downward adjustment from current operating expense levels in the proposed regulation in order to project stress test operating costs that are both reasonable and consistent with a "no-new-business" environment. Any increase in foreclosed property expenses related to stress test defaults is already fully captured in the proposed regulation's loss severity projections.

Interest-Rate Risk and Credit Risk Should Be "Netted"

Two commenters suggest that the capital model should separately measure interest rate and credit risk. Presumably, OFHEO would base risk-based capital requirements upon the sum of the two risk exposures. This suggestion runs counter to statutory requirements and is both conceptually flawed and operationally infeasible.

The 1992 Act requires that total capital needed to pass the stress test be "…determined in accordance with generally accepted accounting principles."[1] Thus, risk-based capital requirements are to be based upon a stress test simulation of the Companies' performance as measured by projected pro forma financial statements. Even if it were possible, stand-alone evaluation of credit risk and interest-rate risk would not allow for any meaningful projection of corporate financial statements.

More fundamentally, credit and interest-rate risks are not separable when dealing with mortgages. Interest rate movements clearly affect mortgage credit risk. Borrowers who pass on refinance opportunities when there are clear financial costs to doing so are clearly more likely to default. Further, voluntary prepayments motivated by interest rate moves or housing turnover reduce cumulative default rates because some of those prepaying would have eventually defaulted due to home price declines or economic reversals. Joint estimation of mortgage defaults and prepayment is therefore required to correctly measure credit risk.

"Tail Risk" Should Be Reflected in the Capital Requirement

Two commenters note that the proposed stress test does not consider potential loss exposure beyond the 10-year stress period. They suggest the regulation should require that our book-of-business at the end of the stress period be marked-to-market in order to capture this potential "tail risk." Such treatment would violate the statutory mandate that risk-based capital requirements derive from a 10-year stress test.[2] Additionally, the concept ignores an important benefit of the proposed regulatory structure. Unlike the ratio-based standards applied to banks and thrifts, the proposed risk-based capital standard dynamically captures changes in the Companies' risk profiles. If the "tails" contain some hidden structural exposure, for example, a substantial mismatch between assets and debt repricing 12 years in the future, these risks would be captured in future quarterly calculations as they fell within the 10-year window. More importantly, unless OFHEO adopts the recommendation of Fannie Mae and several others regarding the use of more balanced refunding rules, the ending position will be highly contrived in any case, with mortgage assets funded almost entirely with short-term debt.

The risk-based stress test already embodies extreme, hypothetical interest rate movements combined with nationwide credit stress equal to the worst-ever regional experience. Attempting to quantify supposed risk beyond the tenth year of a financial simulation simply lacks

[1] The statute establishes that each company is "adequately capitalized" if it maintains "an amount of total capital" equal to or exceeding the risk-based capital level under the stress test. "Total" capital is defined as the combination of "core capital" and other listed items; "core capital" must be determined in accordance with generally accepted accounting principles. 12 U.S.C. §§ 4502(4), 4502(18)(A), 4614(a)(1).

[2] The required amount of capital must be "sufficient for the enterprise to maintain positive capital during a 10-year period in which" the stress scenarios occur. 12 U.S.C. § 4611(a).

credibility, given that results invariably reflect future assumptions and not the current business risk profile.

Supplemental Tests for Determining Risk-Based Capital

Four commenters recommend that OFHEO adopt supplemental tests for risk-based capital that are not contemplated by the statutory requirements. These include suggestions that OFHEO apply: (1) Value at Risk (VaR) analysis to augment the statutory stress test capital adequacy evaluation; and (2) supplemental and more moderate interest-rate risk changes, in addition to those specified by statute.

Value at Risk

Fannie Mae agrees that value-at-risk estimates are a valuable tool for risk management and uses them for its internal risk management, but does not believe they should play a role in determining regulatory capital for Fannie Mae and Freddie Mac. A market liquidation approach based upon VaR-generated prices fails to meet the legislative mandate for development of a risk-based capital standard tied to simulated financial results using an earnings-based, 10-year stress test model. In addition, implementation of such market value functionality into the proposed rule would greatly increase the regulation's overall complexity and invariably delay rapid progress toward final implementation.

Supplemental Interest Rate Movements

Another recommendation was for OFHEO to subject Fannie Mae and Freddie Mac to more moderate interest rate movements along with the extreme rate shocks specified by statute. These commenters assert that this will provide a more robust determination of capital adequacy. In fact, more moderate shocks most likely will result in lower capital requirements by virtue of their being more moderate. The extraordinary shocks stipulated by statute are a true test of extreme risk. In scenarios that are less extreme, the cost to capital most likely will be correspondingly lower. For this reason, the statute does not require intermediate rate shocks in the estimation of required risk-based capital.

Furthermore, we believe that augmenting the stress test with additional rate shocks would needlessly complicate the process of determining required risk-based capital. As part of its existing risk management practice, Fannie Mae already examines risk exposures using a variety of techniques, including value-at-risk and other measures that involve numerous types of interest rate shocks. These risk management practices and policies are, and will continue to be, thoroughly examined by OFHEO. The examination process continues to provide valuable additional assurance of the integrity of risk management at the Companies, over and above what is specified in statute for required capital.

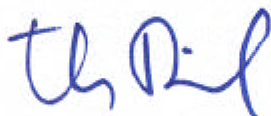
Conclusion

A consensus has emerged supporting the principles of operational workability, accommodating innovation, and tying capital to true economic risk. The comments represent a broad spectrum of interests and, in many cases, offer remedies similar to those outlined in our comment and that of Freddie Mac. There is also a clear desire to bring the rulemaking process successfully to closure, in the very near future.

As we note, a minority of respondents offered comments that, unfortunately, exacerbate rather than correct flaws related to the three principles above. We identify these comments and note briefly our perspective on each.

The option of adopting OFHEO's original proposal, as is, promises substantial further delay both in the rulemaking and at each required quarterly reconciliation for the indefinite future. Respectfully, we urge OFHEO to carefully consider the recommendations offered in our March 10 comment letter. We look forward to providing any further assistance that may help bring this process to a timely and productive close.

Sincerely,



Thomas E. Donilon