



Housing Policy Council
1750 K Street NW Suite 300
Washington, DC - 20006
202-589-1923
www.housingpolicycouncil.org

August 31, 2020

Mr. Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
Eighth Floor
400 Seventh Street, SW
Washington, DC 20219

Re: Enterprise Regulatory Capital Framework; RIN 2590-AA95

Dear Mr. Pollard:

The Housing Policy Council (“HPC”)¹ appreciates the opportunity to comment on the Enterprise Capital Framework proposed by the Federal Housing Finance Agency (“FHFA”) on June 30, 2020.² HPC members have substantial engagement with Fannie Mae and Freddie Mac (the “Enterprises”) as originators and servicers of residential mortgage loans that are securitized by the Enterprises, as counterparties to the Enterprises in credit risk transfer structures, and as private mortgage insurers. As such, the members of HPC have a direct interest in the impact of the proposed capital framework on the pricing and business decisions of the Enterprises, as well as the manner in which the framework contributes to a competitive, equitable, and sound housing finance system.

Our comments on the proposed framework are divided into three parts. In Part I, we offer some general comments on the proposed rule and summarize our recommended changes in the proposed rule. In Part II, we address, in detail, our recommended changes to the proposed rule. Part III is a conclusion. We also have included supplementary information in the Appendices attached to this letter. In Appendix A, we provide data on the calibration of the leverage ratio. Appendix B lists pre-crisis examples of credit risk transfer-like transactions. Appendix C addresses the economics of credit risk transfers. Appendix D addresses lender risk share transactions. Appendix E is our comments on the questions posed by FHFA in the preamble to the proposed rule.

I. General Comments

A. HPC Supports the Establishment of a New Capital Framework for the Enterprises.

For the operational and pricing decisions the Enterprises must make in conservatorship, and in anticipation of the release of the Enterprises from conservatorship, and, ultimately, the enactment of housing finance reform legislation that

¹ HPC is a trade association comprised of the nation’s leading mortgage lenders, services, mortgage insurers, and title and data companies. HPC advocates for the mortgage and housing finance interests of its members in legislative, regulatory, and judicial forums. Our interest is in the safety and soundness of the housing finance system, the equitable and consistent regulatory treatment of all market participants, and the promoting of lending practices that create sustainable home ownership opportunities leading to long-term wealthy-building and community-building for families.

² 85 Fed. Reg. 39274 (June 30, 2020).

repeals the Enterprises special charters and ushers in a more competitive secondary mortgage market, greater regulatory clarity on capital is needed.

HPC appreciates the effort FHFA has devoted the past several years in developing a new capital framework for the Enterprises. The revised version set forth in the proposed rule is an improvement over the 2018 proposal in many ways, but there are opportunities to improve on it. HPC recognizes and appreciates that many of our core concerns raised with the 2018 proposal have been addressed in this version. Still, as described in this letter, there are several key shortcomings that HPC believes FHFA must address before finalizing the rule.

B. The Enterprises are “Hybrid” Institutions that Combine Banking and Insurance Attributes.

In the preamble to the proposed rule, FHFA states that the proposed rule is based upon a “going concern” standard, which may be contrasted with calibrating capital based upon a “claims payment capacity” or an “insurance-like” standard.³ HPC agrees with the need for capital to support the Enterprises as going concerns but views them as “hybrid” institutions that combine both banking and insurance attributes.

Commercial banks, as owners of mortgage credit risk, share similarities with the Enterprises as portfolio investors in mortgages. As such, the capital required to support prime mortgage credit risk held by banks and the capital necessary to support substantially similar risks held by the Enterprises should be comparable. Likewise, the systemic risk posed by the Enterprises is comparable to the systemic risk posed by the nation’s largest banking organizations. Thus, the capital buffers and other systemic risk capital charges banking regulators impose on the nation’s largest banking organizations should form the basis for comparable capital assessments for the Enterprises.

There are, however, fundamental differences between the operations of the Enterprises and banks. Banks do not engage principally in the mortgage credit guarantee business, which is the core business of the Enterprises. The credit guarantee business is generally viewed as an insurance business, with the closest analogy being the mortgage insurance industry. Moreover, unlike banks, the Enterprises do not rely upon deposits for funding, so they do not face the same liquidity and interest rate risk as banks. Additionally, because the Enterprises are focused exclusively on managing mortgage credit risk, the Enterprises do not face credit risk on multiple types of assets as do banks.

In its report on housing finance reform, the Treasury Department stated that similar credit risks generally should have similar risk capital charges across market participants.⁴ We agree that the capital framework for the Enterprises should be aligned with the capital rules applicable to banks to the extent possible in order to discourage regulatory arbitrage.

³ 85 Fed. Reg. 39285 (June 30, 2020).

⁴ Housing Reform Plan, U.S. Department of the Treasury, Sept. 29, 2019, p. 3.

At the same time, we believe that the capital framework should more explicitly acknowledge the insurance-like operations of the Enterprises. As proposed, the capital framework does align with the bank capital framework in many respects, particularly the combination of a leverage ratio, with a buffer, and risk-based capital charges plus added capital buffers. On the other hand, the framework fails to give enough capital relief to credit risk transfers by the Enterprises. The distribution of risk through reinsurance and other forms of credit risk transfer is standard practice in the insurance industry and deserves greater credit than it receives under the proposed capital framework.

C. Clarity on Future Federal Support for the Enterprises is Important – and Must be Addressed – but Should Not Impede the Development of a New Capital Framework for the Enterprises.

The proposed rule is intended to apply to the Enterprises after the conservatorships end. We assume that there will be some continuing level of federal support for the Enterprises post-conservatorship, and that the cost of that support will have some impact on the amount and cost of capital for the Enterprises. Importantly, FHFA's lack of guidance with respect to any post-conservatorship federal support and a framework for anticipated treatment of this support in the calibration of capital standards – whether a congressionally-provided explicit guarantee, a continuation of the PSPA backstop, or no backstop at all – is critical information needed to gauge the economics of the proposed capital framework. We would welcome any insight FHFA could provide on future federal support for the Enterprises but realize that this is policy matter also involves the Treasury Department and Congress.

We also assume that any rule finalized by FHFA may be adjusted in the future to address changes in the level of federal support for the Enterprises, just like the federal banking agencies have made adjustments in the capital requirements for the banking industry in response to changes in market and economic conditions. Therefore, while clarity on the level of federal support for the Enterprises is essential for the market before the conservatorships are ended, it need not impede the development of a new capital framework for the Enterprises. The framework should stand on its own and be adjusted as necessary based upon future developments.

D. Summary of HPC Recommended Modifications to the Proposed Rule.

Throughout the next section of this letter, HPC makes more than a dozen recommendations for modifying the proposed rule. These recommendations include, but are not limited to:

- The treatment of credit risk transfers should be revised to encourage rather than discourage the use of these risk distribution mechanisms;
- The leverage capital buffer should be reduced;
- The risk-based capital buffers should be based upon risk-weighted assets rather than adjusted total assets so that the buffers are risk-sensitive;

- The countercyclical adjustment in the risk-based grids for single-family mortgage exposures should be based upon changes in state-level or MSA-level house prices;
- The counterparty haircut for mortgage insurance should be more transparent and objective;
- The single-family risk multipliers and credit enhancement multipliers should be revised in certain respects; and
- The risk-weight on MBS guaranteed by another Enterprise should be zero, as in the 2018 proposal, to ensure proper functioning of the UMBS market.

While we believe each of these changes is needed, HPC especially emphasizes the criticality of FHFA addressing the first three items. We explain our reasoning in the next section but provide a brief summary here.

The proposed rule's treatment of credit risk transfer would discourage the use of credit risk transfer, treating it more like another risk to be managed rather than as a critical means to absorb credit losses. The result will be more risk of loss being concentrated on the Enterprises' balance sheets, a diminishment of external market monitors and market pricing of mortgage credit risk conditions, and an increase in systemic risk.

The excessive leverage capital buffer would incentivize risk-taking while removing any incentive for credit risk transfers, which over time may jeopardize the adequacy of the capital framework and increase the need for implicit or explicit government and taxpayer support.

Finally, the material departure from the bank framework in basing the prescribed capital conservation buffers on adjusted total assets rather than risk-weighted assets effectively adds another leverage ratio on top of the risk-based requirement. As with any leverage ratio requirement, disregarding the riskiness of assets creates an incentive for increasing risk when the requirement is both binding and unresponsive to asset risk.

II. HPC Recommendations

A. The Leverage Requirement is Overly Conservative and Should be Modified.

HPC supports the establishment of a leverage requirement as a credible backstop to the risk-based capital requirements proposed in the rule. We appreciate that a leverage requirement can safeguard against total assets versus available capital, model risk and other material risks that are not assigned a risk-based capital requirement.

Yet, as FHFA acknowledged in connection with the 2018 proposed rule, a binding leverage requirement can increase risks for the Enterprises. Since a leverage requirement is applied irrespective of an asset's risk, it can incentivize firms to hold riskier assets on their balance sheets.⁵ A binding leverage requirement also is likely to cause an Enterprise to

⁵ 83 Fed. Reg. 33314 (July 17, 2018).

reduce or halt credit risk transfer transactions because the Enterprise would gain no capital relief from the transactions.⁶

This tension between a leverage requirement and risk-based requirements is not unique to this proposed rule. Federal Reserve Vice Chairman for Supervision Randal Quarles spoke to this tension in the bank capital framework:

The proposal to modify the [enhanced supplementary leverage ratio], in particular, initially raised questions in the minds of some as to whether it would reduce the ability of the banking system to weather shocks. A closer look at the proposal shows that the opposite is true. The proposed change simply restores *the original intent of leverage requirements as a backstop measure to risk-based capital requirements*. As we have seen, a leverage requirement that is too high favors high-risk activities and disincentivizes low-risk activities.

We had initially calibrated the leverage ratio at a level that caused it to be the binding constraint for a number of our largest banks. As a result, those banks had an incentive to add risk rather than reduce risk in their portfolios because the capital cost of each additional asset was the same whether it was risky or safe, and the riskier assets would produce the higher return. The proposed recalibration eliminates this incentive by returning this leverage ratio to a level that is a backstop rather than the driver of decisions at the margin. [emphasis added]⁷

In order to balance these conflicting effects, the leverage requirement should be set at a level that maintains the primacy of the risk-based capital requirements and that ensures the Enterprises have enough capital to operate across economic cycles. The leverage requirement in the proposed rule does not achieve this balance. It is more conservative than necessary, and it would have the negative consequences FHFA cited in 2018.

The factors used to size the leverage requirement support a lower requirement.

The proposed rule calls for a leverage requirement of 4 percent, which consists of a base requirement of 2.5 percent and a 1.5 percent leverage buffer. In the preamble to the proposed rule, FHFA states that the 4 percent requirement has been sized to: (1) align with the analogous leverage requirements for banking organizations and the Federal Home Loan Banks; (2) be consistent with the Enterprises' historical loss experiences; and (3)

⁶ 83 Fed. Reg. 33314-33315 (July 17, 2018).

⁷ Randal K. Quarles, "Liquidity Regulation and the Size of the Fed's Balance Sheet" (Remarks at "Currencies, Capital, and Central Bank Balances: A Policy Conference" a Hoover Institution Monetary Policy Conference, Stanford University, Stanford, CA, revised version August 3, 2018).

capture model risk and other risks not captured in the risk-based requirements.⁸ These factors support a combined leverage requirement around 3 percent, not 4 percent.

While banking organizations are subject to a minimum 4 percent leverage ratio, the size of the requirement for the Enterprises should be adjusted to reflect the differences between the Enterprises and banking organizations in both funding and credit risk. The leverage requirement applicable to banking organizations is designed, in part, to mitigate reliance on short-term funding, which can become unavailable during a stress event.

Given their business model, the Enterprises do not face the same degree of funding risk as banks. As FHFA acknowledged in the 2018 proposal, the Enterprises' guarantee business is match-funded with the mortgage assets they purchase and cannot be withdrawn during times of market stress.⁹ Moreover, the Enterprises are subject to less credit risk than banking organizations. In the preamble to the proposed rule, FHFA acknowledges that the average risk-weight of assets of the Enterprises was 81 percent of the risk-weight of assets of large banking organizations. That difference alone translates to an analogous leverage ratio for the Enterprises of 3.2 percent, not 4 percent.

FHFA's reported Enterprise historical loss data also supports a lower leverage requirement. In the preamble to the proposed rule, FHFA acknowledges that the Enterprises' crisis-era peak cumulative capital losses were \$167 billion or approximately 3.0 percent of their total assets as of December 31, 2007.¹⁰ Similarly, in the 2018 proposed rule, FHFA estimated that the minimum leverage ratio required to cover historical losses on the Enterprises' December 2007 book of business was 2.2 percent.¹¹ We also would note that, given the substantial overhaul and strengthening of the entire regulatory framework for mortgage lending following the 2008 crisis, historical losses from the Enterprise books of business from that period should inform, but not dominate, the calibration of future capital levels.

Our own work suggests that the 4 percent leverage requirement appears to be excessive relative to the actual credit risk assumed by the Enterprises. Appendix A details this analysis, which is based on the loans in Fannie Mae's Single-Family Loan Performance Dataset as of December 2018. Based on the composition of Fannie Mae's portfolio, if there were to be a repeat of the 2008 crisis, a 4 percent leverage ratio applied to the single-family business would result in Tier 1 capital covering lifetime portfolio losses by 4-5 times. This assumes all losses are recognized immediately and there is no offsetting benefit from net revenues before credit provisions, an unrealistically severe stress scenario. Net of risk-sharing by CRT, we estimate this coverage of stressed losses improves to 5-7 times. This is a level of capital redundancy that is excessive, if not highly punitive. If FHFA were to target a trough risk-based CET1 ratio of 4.5 percent, similar to the historical bank CCAR threshold,

⁸ 85 Fed. Reg. 39294 (June 30, 2020).

⁹ 83 Fed. Reg. 33326 (July 17, 2018).

¹⁰ 85 Fed. Reg. 39294 (June 30, 2020).

¹¹ 83 Fed. Reg. 33381 (July 17, 2018).

our estimates suggest that the minimum leverage ratio might more appropriately be calibrated to a 2.5-3.0 percent range.

The leverage requirement should provide guardrails for model risk and other risks not captured in the risk-based capital requirement. However, model risk can be reduced by using multiple models to produce the risk-based requirements, which FHFA has already done. Additionally, the multiple buffers and other features incorporated in the risk-based capital requirement mitigate model risk. The risk grids incorporated in the proposed rule are fundamentally the same as the grids proposed in 2018, and at that time FHFA noted that it used multiple models in producing those grids in order to reduce model risk.¹²

An excessive leverage ratio requirement renders credit risk transfers uneconomic.

By design, the leverage ratio is a function of total adjusted assets and is unrelated to any measure of the underlying riskiness of the regulated entity's assets or operations. A key reason to maintain a leverage ratio in addition to a risk-based capital framework is to ensure against gaming of, or shortcomings in, the risk-based formulas.

A casualty of a binding leverage ratio is the removal of incentives to align capital and risk-taking. That is why a binding leverage ratio is said to incent greater risk-taking. In the case of the Enterprises, a binding leverage ratio could result in weakened underwriting standards among other things. Another direct casualty would be credit risk transfers.

As explained in greater detail later in this letter, credit risk transfer, or CRT, effectively transfers a substantial share of the Enterprises' core risk – mortgage credit risk – to private investors. In effect, these investors become a meaningful source of loss-absorbing capacity supporting the Enterprises' guarantee business.

While the risk-based capital framework reduces the Enterprises' risk-based capital requirements in recognition of CRT protection, the leverage ratio does not. The substantial leverage capital buffer proposed in the rule makes the leverage ratio the binding capital requirement at the as-of date used in the proposal and likely binding most, if not all, of the time going forward. As a result, the Enterprises will lose any capital benefit from CRT and thus lose any incentive to continue with CRT. As explained further below, the numerous benefits of CRT then would be lost, risk-taking would increase, and systemic risk would increase.

HPC recommends that the leverage buffer be reduced to 0.5 percent.

As the forgoing discussion indicates, a 3 percent leverage requirement would achieve alignment with bank capital rules, consistency with historical losses, a high level of redundancy to cover losses on post-crisis portfolios, and would address model risk and other risks not captured in the risk-based capital requirement. Therefore, we recommend that FHFA adopt a 3 percent leverage requirement by reducing the leverage buffer (PLBA) to 0.5 percent from 1.5 percent. Adjusting the leverage buffer would maintain the base

¹² 83 Fed. Reg. 33325 (July 17, 2018).

leverage requirement of 2.5 percent, which FHFA had proposed in 2018 and re-proposed in 2020,¹³ and still provide a cushion to address risks not captured in the risk-based requirements. This change also would bring the relative size of the buffer compared to the base requirement more in line with the leverage buffer applicable to large banking organizations.¹⁴

Additionally, as discussed further below, HPC recommends adjustments to the risk-based capital requirements to give more capital offset credit for credit risk transfer. Enhancing CRT credit while not adjusting the leverage requirement will simply increase the likelihood that the leverage requirement will be binding and thus CRT rendered ineffective as a capital offset.

B. The Mortgage Risk Grids are Reasonable, but the Countercyclical Adjustment Should be Refined.

The foundation for the proposed rule's risk-based capital requirement for single-family mortgage loans is a set of "look-up" grids based upon loan-to-value (LTV) ratios, borrower credit scores, and the performance status of the loans. The risk-weights reflected in these grids were calibrated based upon estimates of unexpected losses from the Enterprises' internal models and FHFA's publicly available model under the severely adverse scenario used in the DFAST stress test, which assumes a 25 percent decline in house prices.

HPC finds the risk-weights assigned by these grids to be reasonable. They are generally consistent with the losses calculated by the internal models used by HPC members. By imposing a risk-weight floor, the risk-weights in the grids maintain some cross-subsidization of higher-credit-risk borrowers by lower-credit-risk borrowers, which has long been a feature of the Enterprises' pricing.

Similar to the 2018 proposed rule, the proposed rule uses mark-to-market loan-to-value (MTMLTV) ratios in the grids. In our comment letter on the 2018 proposed rule, we expressed concern with the pro-cyclical impact of MTMLTVs, and we recommended that FHFA consider a countercyclical adjustment tied to house prices. We appreciate that FHFA

¹³ In 2018, FHFA proposed two alternative measures for the leverage requirement, one of which was a 2.5 percent requirement. The 2.5 percent requirement represented a mid-point between 2.2 percent and 2.8 percent that was derived from an analysis that involved: (1) adjusting the 4 percent bank leverage ratio for the relative risk of the Enterprises' business; (2) determining the capital threshold for bank downgrades and adjusting the threshold for the relative risk of the Enterprises' business; (3) determining the capital threshold for bank failures and adjusting the threshold for the relative risk of the Enterprises' business; (4) analyzing the lifetime credit losses on the Enterprises' December 2007 books of business, with adjustments for loans the Enterprises no longer acquire and for credit risk transfers; and (5) analyzing the CCF risk-based capital requirement on the Enterprises' September 2017 books of business, with adjustments for loans the Enterprises no longer acquire and for credit risk transfers. (See 83 Fed. Reg. 33380 (July 17, 2018)).

¹⁴ At 1.5 percent, the proposed buffer is approximately 40 percent of the total leverage ratio. The buffer for G-SIBs is closer to 20 percent of the ratio. A 0.5 percent leverage buffer would be 16.67 percent of the overall leverage requirement.

has incorporated such a countercyclical adjustment in the proposed rule. However, we believe that the countercyclical adjustment should be refined.

HPC recommends that the countercyclical adjustment be based upon state level or even MSA level housing prices.

The countercyclical adjustment in the proposed rule is tied to changes in national housing prices. Yet, housing prices vary widely in different parts of the country and using a national house price index will obscure the “true” house price appreciation occurring in local markets. Therefore, we recommend that the countercyclical adjustment be based upon changes in state level or even MSA level house prices. This would enhance the countercyclical impact of the adjustment. Also, this change in the design of the adjustment would accommodate new entrants that may operate in different geographies.

HPC recommends that FHFA consider the use of a modified combination of MTMLTV and OLTV ratios to reduce the countercyclical impact of the framework.

The pro-cyclical impact of MTMLTVs, particularly during periods of rapidly changing house prices, could be mitigated by delaying the transition from OLTVs. The proposed rule provides for the use of OLTV ratios for only the first six months of a loan. Since most mortgage defaults occur within 60 months of origination, FHFA should extend the use of OLTV ratios for a longer period, e.g., 36 to 60 months. This would reduce the pro-cyclical impact of the rule, and permit mark-to-market adjustments after a loan has seasoned.

That modest change in approach would prevent rapidly rising (falling) house prices from lowering (raising) LTV on newly originated loans during the initial years when defaults are most likely. By preserving a mark-to-market adjustment of LTVs to account for house price changes after the initial seasoning, FHFA and the Enterprises would have the benefit of new information that is material to the overall risk assessment (and capital requirement) of seasoned mortgages. That information then can better inform the setting of the risk-based capital requirements.

HPC recommends that FHFA not update credit scores.

With regard to the borrower credit scores used in the grids, HPC recommends that original credit scores be used in the grids rather than updated credit scores. Since there is a cyclical component to credit scores, this adds an unnecessary pro-cyclical component to capital requirements. And unlike the LTV factor, there is no easily defined countercyclical guardrail for credit scores.

The original credit score remains a significant indicator of borrower default probability over time. In addition, credit scores are influenced by the amount of debt a borrower is carrying – a fact that also carries over into a borrower’s DTI ratio – and yet the DTI adjustment is fixed over the life of the loan, as opposed to being updated for changes in the borrower’s income and debt loan.

Furthermore, using updated credit scores could result in the double-counting of risk since credit score declines accompany mortgage delinquencies. In other words, when a loan goes delinquent, there would be an impact on the capital calculation based upon both the decline in the borrower's credit score and the delinquency of the loan.

C. The Capital Buffers in the Risk-Based Capital Calculation Should be Revised.

The proposed rule calls for the Enterprises to maintain three risk-based capital buffers to avoid incurring limits on capital distributions and discretionary bonus payments. These three buffers, collectively the prescribed capital conservation buffer amounts (PCCBA), would be: (1) a stress capital buffer set at 0.75 percent; (2) a countercyclical buffer, which would range from 0.0 percent to 0.75 percent and be adjusted based upon macro-financial conditions; and (3) a stability buffer, which would be based upon an Enterprise's share of mortgage debt outstanding.

HPC recommends that the capital buffers be based upon risk-based assets.

The percentage requirements associated with these buffers in the proposed rule would be based upon an Enterprise's adjusted total assets, rather than risk-based assets. The preamble to the proposed rule states that using adjusted assets rather than risk-based assets is a "notable" departure from the Basel framework, but that this approach is needed to reduce the impact that the buffers could have on higher risk exposures, avoid amplifying the secondary effects of any model or similar risks inherent to the calibration of the risk-weights for mortgage exposures, and mitigate the pro-cyclicality of the risk-based capital requirements.¹⁵

We recommend that the capital buffers be based upon risk-based assets, not adjusted total assets. The size of these buffers would have to be revisited since the denominator in the calculation is changing, but we estimate that requirements consistent with those mandated for systemically important domestic banks would be appropriate for the Enterprises. Basing the capital buffers on adjusted total assets rather than risk-based assets means that the buffers are additional leverage requirements, not risk-based requirements. The dominant feature of the capital framework for the Enterprises should be the risk-based capital requirements. The leverage requirements should be a backstop, not the binding requirements. As discussed above, we believe that the proposed leverage capital buffer should be reduced to ensure that the leverage requirements are a backstop and not the dominant on-going requirements. Basing the prescribed capital conservation buffer amounts on adjusted total assets goes in the wrong direction.

Also, this proposed departure from the Basel framework is not necessary. The risks that FHFA seeks to capture by tying the capital buffers to adjusted total assets are captured elsewhere in the framework. The base leverage requirement captures residual model risks

¹⁵ 85 Fed. Reg. 39296 (June 30, 2020).

not captured in the risk-based requirements, and FHFA has incorporated other features in this proposal specifically aimed at reducing the pro-cyclical impact of the framework.

The countercyclical buffer should be more tightly defined.

As proposed, the countercyclical buffer would not be tied to the mortgage market, per se, but would be a regulatory response to general credit market conditions. Moreover, FHFA has proposed to condition the use of the buffer on a determination by federal banking regulators that general credit market conditions suggest there is “excess aggregate credit growth.”¹⁶ HPC concurs with this proposed buffer and its anticipated use.

We recommend that FHFA make this alignment with the banking regulators a formal part of the rule. Since FHFA has indicated its expectation that the buffer would be deployed in coordination with the banking regulators’ actions based on aggregate credit conditions, FHFA should go a step further and amend the rule to explicitly tether any use of this buffer to similar deployment of the buffer by the banking agencies. Furthermore, the buffer should include a phase-in period and time limitation consistent with those of the banking agencies. Making these adjustments would further align the operation of this capital framework with that of the banking regulators and reduce the opportunity for capital arbitrage across the two systems.

D. Greater Credit Should be Given to Credit Risk Transfers.

The proposed rule’s treatment of credit risk transfer (CRT) is among the most critical elements of the entire framework. HPC believes the proposed treatment recognizes the ways in which CRT is not a perfect substitute for common equity capital, yet it falls short in recognizing the full extent of the risk-distributing benefits of CRT to the Enterprises and more broadly to the stability of the mortgage finance system.

In short, we find the proposed treatment of CRT to be overly punitive and uneconomic. The proposed rule disincentivizes the use of CRT. This will have the perverse effect of concentrating risk of loss in the Enterprises, leading to the same systemic risk challenges that were central to their failure in 2008. HPC recommends that the proposed treatment of CRT be revised to strike a better balance between encouraging an appropriate quantity of capital at the Enterprises and fostering the distribution of risk.

HPC Believes CRT is a critical, market-based risk mitigant.

In 2012, FHFA, in its capacity as a conservator, directed the Enterprises to establish loss-sharing arrangements that would shift some portion of the mortgage credit risk retained by the Enterprises to private investors. In 2013, the Enterprises began what we now call credit risk transfer transactions, or CRT.

¹⁶ 85 Fed. Reg. 39277 (June 30, 2020).

By shifting credit risk from the Enterprises to private investors, CRT accomplishes several important public policy objectives. CRT:

- Attracts a broad set of investors that analyze and price the mortgage credit risk held by the Enterprises and that assume some of that risk using their own capital;
- Reveals actual market prices for the mortgage credit risk held by the Enterprises, which proves useful during periods of market strength and weakness;
- Balances the mix of capital held by the Enterprises between common equity, other capital, and CRT to promote the effective deployment of capital, maximizing pricing efficiency and benefiting home buyers by lowering mortgage rates;
- Substantially reduces the concentration of mortgage credit risk on the Enterprises' balance sheets and thereby reduces systemic risk;
- Reduces the amount of capital the Enterprises need to support their guarantee business; and
- Reduces the exposure of taxpayers to the Enterprises.

Since the start of the use of CRT, FHFA has encouraged the Enterprises to develop multiple forms of CRT, including securities issuance, insurance/reinsurance transactions, and risk-sharing with lenders. While early versions of these structures may have been relatively unrefined, they have evolved to effectively transfer credit risk.¹⁷ Moreover, the market demand for these products is strong, indicating that there is a deep pool of investors, across various execution channels, ready to invest in these structures. FHFA's most recent progress report on CRT indicates that credit risk on over \$3 trillion of mortgage loans has been transferred through CRT since 2013.¹⁸

Recognizing that CRT enhances taxpayer protection and fosters price discovery and market discipline, the Treasury Department has recommended that FHFA provide for the continued development of CRT as part of the capital framework for the Enterprises:

FHFA should, in prescribing regulatory capital requirements, provide for appropriate capital relief to the extent that a guarantor... transfers mortgage credit risk through a diverse mix of approved forms of CRT.¹⁹

Additionally, on the same day that the proposed rule was published in the Federal Register, the Secretary of the Treasury and the Chairman of the Federal Reserve Board expressed support for the continued development of CRT in a Congressional hearing:

¹⁷ Don Layton, *De-Mystifying Credit Risk Transfer: Part I - What Problems are We Trying to Solve*, Joint Center for Housing Studies for Harvard University, January 2020.

¹⁸ Credit Risk Transfer Progress Report, Federal Housing Finance Agency, Second Quarter 2019, p.1.

¹⁹ Housing Finance Reform Plan, U.S. Department of the Treasury, Sept. 2019, p. 30.

REP. LUETKEMEYER: I ask each of you gentlemen whether you still agree that it is appropriate that the enterprises should receive meaningful capital credit for sound CRT transactions they conduct with sound counterparties and avoid the accumulation of credit risks on the balance sheets of two institutions that remain taxpayer backed. One of you?

SECRETARY MNUCHIN: Yes. I agree that they should receive relief, that we should encourage them to do credit risk transfers with creditworthy counterparties. And that I can also tell you FSOC is beginning to review these issues as well.

REP. LUETKEMEYER: Chairman Powell, can you comment on this as well?

CHAIRMAN POWELL: Yes. I do agree and we're actually in the middle of doing a careful review of the whole capital proposal as well.²⁰

In pure economic terms, the Enterprises are incented to transfer risk when the cost of capital from CRT is about the same or less than raising equity capital to hold the risk internally. From a regulator's standpoint, though, there are additional considerations for encouraging the use CRT.

CRT lessens the systemic risk posed by the Enterprises by reducing the concentration of that risk on the Enterprises' balance sheets and the volatility inherent in the credit performance of the Enterprises' guarantee business. It does so by introducing a range of other active participants with an economic stake in monitoring mortgage market credit conditions to contain risk. These added participants mitigate risk-assessment and risk-management errors by the Enterprises. Also, introducing other deeply subordinated investment classes in mortgage credit risk beyond just Enterprise equity instruments, broadens the array of market signals regarding mortgage credit risk.

Furthermore, the CRT market brings greater transparency to the market pricing of mortgage credit risk, and that transparency fosters competition, which promotes lower mortgage rates. Since the 2008 financial crisis, Enterprise-issued CRT bonds have become the benchmark instrument in the capital markets for pricing U.S. mortgage credit risk.

We recognize that there may be temporary market disruptions that impact investor interest in CRT, especially with the securities transactions. Indeed, for a short time, this was observed in the initial weeks of the COVID-19 national emergency. That experience does not mean that CRT is flawed. The market appetite for new CRT has already returned. The recent volatility in CRT is an argument for maintaining multiple avenues for CRT distribution, not reducing the use of CRT as a risk mitigant.

²⁰ Transcript of Hearing of the U.S. House Committee on Financial Services. "Oversight of the Treasury Department and Federal Reserve's Pandemic Response," June 30, 2020.

Some market disruption is a trade-off for having a system that continually requires going into the market to get new bids on mortgage credit risk. In other words, having an actionable flow of information is a market strength not a hindrance. Market signals at a given moment might be unsettling, but that does not mean that the signal itself is not conveying valuable information about a changing risk environment.

Temporary market dislocations, such as seen in the early period of COVID-19 when most markets for risky assets sold off, should not be a major concern since the market should be willing to absorb the risk after market volatility subsides. Moreover, other features of the proposed rule, most notably the stress capital buffer, are specifically designed to ensure that the Enterprises have enough capital in times of stress. Such a buffer enhances the Enterprises' ability to maintain secondary market liquidity for loan originators during episodes of market dislocation – a core public purpose of the Enterprises.

With the foregoing comments as background, HPC offers the following observations about FHFA's characterization of single-family CRT and its proposed treatment of single-family CRT in the capital rule:

CRT is not equity – but it has equity-like features.

The preamble to the proposed rule highlights that CRT has less loss absorbing capacity than equity financing, and that it cannot cover operational and market risk losses.²¹ This is the heart of FHFA's justification for discounting the loss absorbing capacity of CRT. On its face, these concerns are accurate. CRT does not absorb losses in the exact manner as common equity. Yet, simply comparing CRT to common equity does not tell the whole story, especially given the Enterprises' business model.

CRT was not designed to absorb operational and market risk losses. Similarly, the core of the proposed capital framework – the risk-based assessments for mortgage credit risk – is not designed to capture those risks. The proposed rule includes separate capital charges for operational and market risks. Moreover, the dominant business risk in the Enterprises' securitization business is managing and distributing mortgage credit risk; CRT is very effective at transferring that risk.

FHFA also observes in the preamble to the proposed rule that specific CRT transactions are tied to a specific set of loans, not to an Enterprise's entire book.²² We acknowledge that this might be a relevant concern if CRT were randomly executed on just some of the book of business. However, FHFA set a 2019 scorecard goal for the Enterprises to have CRT cover at least 90 percent of credit risk associated with all newly acquired single-family mortgages in targeted categories.²³ Since the loans not subject to CRT also are the least risky (very low LTV loans and 15-year mortgages), this amounts to CRT

²¹ 85 Fed. Reg. 39330 (June 30, 2020).

²² Ibid.

²³ Credit Risk Transfer Progress Report, Federal Housing Finance Agency, Second Quarter 2019, p. 2.

covering the vast majority of mortgage credit risk held by the Enterprises, making it functionally capable of covering almost all potential unexpected single-family credit losses.

Stated differently, so long as the Enterprises are programmatic in their use of CRT, the benefits will be available at the time the economic stress hits. While the price and availability of new CRT issuances may be temporarily affected by the stress, the loss absorption benefit of the existing structures are exactly what will provide loss absorption for the Enterprises.

HPC applauds FHFA for setting an aggressive goal on the use of CRT by the Enterprises, but we are perplexed as to why FHFA's proposed rule would apply such a deep discount to the credit protection provided by CRT. We believe that FHFA should take into consideration the loss absorbing *and* risk distribution properties of CRT. CRT securities transactions are paid-in cash. There is no counterparty risk; the cash is placed in trust from the outset. Whatever market turmoil follows, the money is there to absorb losses per the terms of the transaction. These structures also include delinquency triggers that preserve this form of capital in an economic stress environment.

FHFA suggests that, as debt instruments, CRT securities impose a cash-flow responsibility on the Enterprises that cannot be turned off like dividend payments. However, this is no different from the premiums businesses and consumers must pay to maintain desired insurance coverage. Because the CRT investors' principal is directly at risk, there is substantial, equity-like investor exposure that promotes market discipline. CRT's function is complementary to that of other capital providers.

With CRT, each individual transaction is subject to specific examination of its credit risk characteristics when the transaction is priced and as it subsequently trades in the market. That means CRT investors care a lot about the specific credit risks in the transaction because they do not benefit from the performance of the broader portfolio. That heightened risk oversight of each transaction should be seen by FHFA as a valuable risk mitigant to the entire book and one that should be fostered and encouraged, not dismissed as inferior to common equity and therefore not valued. Indeed, one important lesson learned from the 2008 crisis was that national diversification across a large mortgage credit book is not in itself a sufficient risk mitigant.

In the end, the treatment of CRT in the capital framework is not an either/or question. The goal should be to maintain prudent levels of both equity capital and CRT. This would enable the Enterprises to benefit from the unique loss absorbing and risk mitigating features of both forms of capital. In economic terms, we believe CRT acts more like permanent capital than FHFA gives it credit for in the proposed rule.

Transparent markets and a rigorous capital framework will foster efficient market pricing and allocation of risk.

The proposed rule goes to great lengths to ensure that both the quantity and quality of Enterprise capital is sufficient and aligned with the bank framework, where appropriate.

FHFA also recognizes that there are multiple types of capital and that the more resilient the capital, the more expensive it is. This is why it is common among all large financial institutions to utilize multiple capital instruments.

A transparent market generally prices various capital instruments (the capital stack) efficiently, balancing each instrument's resiliency and place in the loss waterfall with its cost. Having sufficient CET1 and other Tier 1 capital reduces the cost of other capital instruments. CRT investors look to the capital depth of an Enterprise to assess the overall resiliency of the Enterprise to sustain losses and still effectively service CRT transactions. A balance between common equity, other capital, and CRT promotes the effective deployment of capital at the most efficient cost and benefits home buyers in the form of lower mortgage rates. Additionally, it fosters a smoother emergence of the Enterprises from conservatorship. Overly punitive discounting of CRT capital treatment disrupts that efficient capital allocation and raises borrowing costs.

FHFA has the authority to remedy weaknesses it sees in design of CRT structures.

FHFA suggests there could be "unique legal risks posed by the contractual terms of CRT structures and by the practices associated with contractual enforcement."²⁴ If FHFA believes that certain CRT structures or Enterprise interpretations of their contractual requirements are inadequate, then FHFA already has the authority to articulate the flaws and direct changes to remedy the weakness and, in the extreme, to simply prohibit that particular structure. Rather than discounting the loss coverage granted to all CRT because FHFA has concerns with certain terms in a CRT structure, FHFA should require that the troublesome terms themselves be corrected.

HPC strongly believes that FHFA should continue to encourage new CRT structures in the future. This will help to drive innovation while not losing key elements of CRT, such as substantive risk transfer and the elimination of counterparty risk.

Also, to preserve market confidence, FHFA should avoid changing the rules once a CRT structure is in place. The level of capital protection a given CRT is allotted at the time of its creation should not change after the fact. After-the-fact changes in capital treatment would alter both the respective incentives of the Enterprise and the investor as well as the market price of the security or guarantee contract.

It also bears noting that there were more than 30 mortgage credit risk transfer-like structures in place prior to the 2008 financial crisis. Each of these structures performed as designed despite absorbing sizeable losses due to the impact of the crisis on residential mortgages. Indeed, these structures provided the exact credit protection expected of them and the applicable bank regulatory guidance provides solid evidence that well written CRTs that meet these requirements are expected to perform during the next economic

²⁴ 85 Fed. Reg. 39330, June 30, 2020.

downturn and continue to offer a model for FHFA to reference. Appendix B to this letter provides additional information on these pre-crisis CRT deals.

The proposed rule negates the concern that an Enterprise could rely too much on CRT.

CRT was never intended to be, nor can we envision a state of the world in which CRT would be, the dominant form of capital for the Enterprises. Therefore, we support FHFA's position of having a meaningful leverage ratio that is satisfied without CRT. The leverage ratio is a rigorous requirement that ensures each Enterprise will operate with a sufficient level of equity capital. That said, the Enterprises' core risk is credit risk and CRT is an efficient and effective mechanism for absorbing mortgage credit losses.

HPC further observes that securities-based CRT, like other forms of capital, can itself be funded by investors using leverage. Use of leverage within the financial system is not novel, and where that risk resides is a matter that policymakers have consistently grappled with over time. Markets regularly reward and punish the use/misuse of leverage and such risk and reward would be handled external to the Enterprises by sophisticated investors and financial regulators.

As already noted, the market disruptions caused by the unprecedented economic shutdown due to COVID-19 only briefly disrupted the CRT market. This event adversely affected almost every other global credit market, many of which, in contrast to CRT, benefitted from central bank intervention to stabilize. The CRT market also withstood brief disruptions due to severe natural disasters in 2017. HPC's view is that it is better to place some of that risk outside the Enterprises than concentrate all of it inside them.

FHFA's overlapping and excessive CRT haircuts treat CRT as an added risk instead of a risk mitigant.

The core business activity of the Enterprises is the guarantee that UMBS investors will receive timely payment of interest and scheduled payment of principal, regardless of whether the borrower makes a full and timely mortgage payment or not. This financial guarantee is essentially an insurance policy. Loss transfers, reinsurance, and other forms of risk-sharing are inherent, and viewed as prudent, in the insurance business model. There is \$625 billion of global reinsurance capital supporting a vast array of risks transferred from primary insurers.²⁵ Mortgage insurance companies also are making increased use of insurance-linked notes to transfer their risk to private investors.²⁶ CRT transactions effectively allow the Enterprises to reinsure their credit guarantees with CRT investors. In CRT insurance transactions, the CRT itself is an insurance contract.

The proposed rule introduces a series of haircuts predicated on the notion that CRT is inherently inferior to the loss absorbing support provided by an Enterprise's retained

²⁵ Aon, "Reinsurance Market Outlook," January 2020, <http://thoughtleadership.aonbenfield.com/Documents/20200108-re-analytics-reinsurance-market-outlook-jan.pdf>.

²⁶ See <https://www.artemis.bm/mortgage-insurance-linked-notes/>.

equity. Yet, the proposed rule takes this argument to an extreme by introducing multiple haircuts and adjustment factors that render CRT economically ineffective as a source of loss absorption capacity. Such treatment is not found in the regulatory capital and reserving requirements of insurance companies or in the regulatory guidance issued by the banking regulators.

FHFA argues that the sum of all tranches, both retained and sold, on any structured transaction, such as CRT, should require more capital than the equivalent underlying risk. HPC does not take issue with that principle. However, we object to the excessive and overlapping haircuts and adjustments that collectively treat CRT as an added risk to the Enterprises rather than a risk mitigant.

These adjustments take three forms: a 10 percent risk-weight floor; a series of effectiveness adjustments that includes a 10 percent haircut on all risk transferred, effectively assigning that risk back to the Enterprise; and a set of operational criteria. Of these, the most consequential and least defensible is the fixed 10 percent risk-weight floor. Although it is argued in the proposal that setting a risk-weight floor is consistent with the spirit of bank capital rules, we believe the treatment here should be calibrated to the hybrid bank/insurance business model of the Enterprises and the particular risks they manage.

The risk-weight floor add-on fundamentally distorts the economics of CRT by requiring that the extremely remote tail risk retained by the Enterprises be treated as a 10 percent risk-weighted asset. In the specific example FHFA uses in the preamble, a \$1 billion CRT pool with expected base losses of merely \$2.5 million (or 0.25%) and risk transfer on up to 4.5 percent of the pool's UPB (equivalent to 18 times expected losses) would still require the Enterprise to hold 8 percent capital against 10 percent of the 95.5 percent retained senior UPB. While FHFA argues that there is risk in this residual tail, no market participant would estimate the risk of loss on that tranche at such a high level. The true retained senior credit risk is negligible and should be treated as such, especially considering the separate 10 percent overall effectiveness adjustment applied to the risk transferred via CRT.²⁷

HPC understands what FHFA is trying to accomplish with the proposed adjustments, but this is exactly where the bank/insurance hybrid structure of the Enterprises requires regulatory judgment. Private market risk transfer solutions, e.g., insurance-linked notes, credit-linked notes and private label securitizations transacted by many insurers and banks, have demonstrated the efficacy of risk transfer and should serve as a guide in the treatment of risk transfer for the Enterprises. HPC's position is that greater deference to

²⁷ FHFA should also consider whether the proposed framework allows for portfolio-level CRT and reinsurance of catastrophic losses (the AH tranche in the stylized example). That is, future risk-transfer deals could be on a portfolio basis, not tied to a specific loan pool. For example, there have been congressional proposals to require reinsurance on a portion of the AH tranche. The rule needs to provide clarity for how such future structures would be treated in terms of the capital relief provided.

the insurance aspects of CRT is needed here. The proposed risk-weight floor is taken directly from the bank capital rule, but, in our view, it is not appropriate. Moreover, the banking rules do not have the separate 10 percent haircut on transferred risk.

In sum, the proposed approach results in CRT receiving materially less capital offset than in the 2018 proposal and ultimately shows little capital relief from risk transfers. As already noted, such an approach over-emphasizes the limitations of CRT without granting any of its benefits.

Therefore, HPC strongly recommends that FHFA revisit the proposed treatment of CRT. We specifically recommend that the 10 percent risk-weight floor be eliminated. At the very least, the floor should be reduced on a sliding scale, as higher detachment points on the sold risk means the risk of loss on retained tranches becomes ever more remote.

The structure of the capital buffers creates disincentives for the Enterprises to utilize CRT for risk mitigation.

In Appendix C, we use FHFA's own stylized CRT structure to illustrate the collective impact of CRT-specific haircuts and the form of risk-insensitive capital buffers on the economics of CRT utilization from the vantage point of the Enterprises. That illustration shows that the overly punitive treatment of CRT, combined with other features of the proposed rule including the overly conservative leverage requirement and the use of adjusted total assets rather than risk-weighted assets in the capital buffers, render CRT uneconomic.

As illustrated in Appendix C, we calculate an effective cost of CRT capital to the Enterprises, assuming that required regulatory capital is the appropriate benchmark, as being materially *higher* than the cost of common equity typically applied by equity market participants to large financial institutions. This is a counterintuitive and undesirable outcome. As a result, the Enterprises will have an economic incentive to retain risk on their balance sheet and the markets will lose the benefit of having a wider array of investors analyzing and holding mortgage credit risk. This amounts to a reversion to a system with excessive concentration of that risk at the Enterprises.

If FHFA is concerned about a potential reduction in required CET1 if the Enterprises use CRT to generate meaningful capital relief, FHFA could adjust the Tier 1 leverage capital requirements so that they must be met using a minimum percentage of CET1 capital. We note the tradeoff would be a reduction in comparability to bank capital requirements. But that reduction in comparability would produce a relatively greater emphasis on holding common equity while incentivizing broader risk distribution via CRT. Meaningful levels of CET1 in conjunction with broad and deep CRT markets are complementary, combining to produce substantial and more resilient loss absorbing capacity while greatly reducing systemic risk. Such an outcome would be vastly superior to a system in which the risk remains exclusively on the Enterprises' balance sheets.

Lender Risk-Sharing is inconsistently addressed in the proposal.

The proposed rule acknowledges, without explanation, FHFA's determination that front-end, single-family mortgage lender risk sharing programs will cease at the end of this year.²⁸ Yet, somewhat inconsistently, the use of lender risk share mechanisms is codified in the proposal for the multifamily business of the Enterprises. HPC urges FHFA to reconsider this decision and to specifically encourage single-family lender risk sharing in the rule.

If FHFA deems a risk transfer structure acceptable for use by an Enterprise, why prohibit a lender from executing the same structure before selling the loans to an Enterprise? Would that not reduce the Enterprise's risk while providing a complementary avenue for the provision of investment capital available for mortgages? In other words, if a CRT structure is good for an Enterprise, it should be good for a lender to use before selling to an Enterprise. In addition to fostering competition, which leads to lower mortgage rates, the alignment of interests in front-end CRT creates a more viable residential lending ecosystem, consistent with the spirit of Dodd-Frank risk retention rules that are mandated for the private capital markets.

Several HPC members and other lenders have successfully executed front-end lender risk-sharing CRT transactions with the Enterprises and would like to do more. Other HPC members also have an interest in such transactions. Therefore, HPC urges FHFA to reconsider its position on lender risk-share.

Appendix D provides additional support for this recommendation and highlights relevant features of forward transactions in mortgage credit risk that align the lender's incentives with those of an Enterprise while also reducing risk (and capital requirements) for an Enterprise. HPC also urges FHFA to consider the pro-competitive aspects of lender risk-share deals and how they may encourage market entry, reduce systemic risk, and improve borrowing rates for consumers.

Treatment of CRT in the rule should be adjusted to achieve important policy goals while ensuring ample capital is available to support the mortgage finance system.

FHFA notes that the capital requirements should ensure the Enterprises' ability to absorb all unexpected losses in a stress environment. Except for the least risky elements of their portfolio, the Enterprises currently engage in meaningful risk transfer on most of their credit book. The various CRT structures in use are calibrated to cover losses well in excess of unexpected losses in a severe economic stress scenario, which is the reason most financial institutions hold capital against retained credit risk. Yet, the capital relief achieved by CRT in the proposed rule is quite small.

FHFA makes repeated references to the risk that loss projection models could underestimate severe stress losses (model risk). Yet, in CRT transactions that risk is absorbed first and principally by the CRT investor, not the Enterprise. In other words,

²⁸ 85 Fed. Reg. 39329 (June 30, 2020).

having CRT with a detachment point well in excess of projected severe stress case losses – consistent with current market practice – insulates the Enterprises from such model risk. Thus, haircuts attributable to such risk are misplaced and concerns about model ineffectiveness become moot as more of the risk is transferred to CRT investors.

As FHFA frequently notes, the Enterprises' Charter Acts require them to foster resilient and competitive national markets. For instance, the Fannie Mae Charter Act states:

The Congress declares that the purposes of this subchapter are to establish secondary market facilities for residential mortgages, *to provide that the operations thereof shall be financed by private capital to the maximum extent feasible* and to authorize such facilities to “...improv[e] the distribution of investment capital available for residential mortgage financing.” [emphasis added]²⁹

Discouraging the use of CRT as a risk distribution and mitigation tool, which is the logical consequence of the current proposal, runs contrary to this Congressional mandate.

E. The Counterparty Haircut Multiplier for Mortgage Insurers and Others Should be More Transparent and Objective.

The proposed rule provides for a counterparty risk adjustment based upon three factors: (1) the creditworthiness of the counterparty; (2) the counterparty's level of concentration in mortgage credit risk; and (3) the counterparty's status as an approved insurer under an Enterprise's counterparty standards for private mortgage insurers. Each of these factors should be more transparent and objective.

HPC recommends that the inputs to the haircut calculation be revised.

The haircut calculation includes the assumption of a loss given default of 35 percent, without differentiation by counterparty type, which ignores the different business models and regulatory structures in play. Mortgage insurers, reinsurers, and even lenders who participate in front-end risk sharing have distinct regulatory requirements. In the case of mortgage insurers, we note that, in connection with the failures of Triad Guaranty, PMI Mortgage Insurance Co., and Republic Mortgage Insurance Company, none of these counterparties have presented a loss-given default approaching 35 percent.³⁰ While we do not have contemporary examples of reinsurers being unable to meet their obligations, it is clear that they would present a more favorable recovery assumption than the proposed rule. While we can look to the world of credit default swaps to estimate what recoveries

²⁹ 12 U.S.C. 1716.

³⁰ Triad Guaranty is currently paying claims in a mixture of 75 percent cash and 25 percent deferred payment obligation (DPO) since entering runoff in 2008. PMI Mortgage Insurance Co. is currently paying claims in a mixture of 76.5 percent cash and 23.5 percent DPO since entering runoff in 2011. RMIC is currently paying claims in full since entering runoff in 2011.

could look like, that proxy is only relevant in cases where there is not a regulatory body designed to protect the interest of policyholders.

HPC recommends that the Enterprises be required to disclose the criteria for rating counterparties.

The proposed rule would require an Enterprise to assign counterparty financial strength ratings using a provided rating framework. These ratings are based upon an Enterprise's assessment of the counterparty's ability to fulfill contractual obligations under foreseeable adverse events. The Enterprises should be required to publish the criteria upon which they base these ratings, including any use of third-party risk assessments. Disclosure of these criteria would enable counterparties to implement policies and procedures that reduce risks to the Enterprises and would help to ensure that they are based upon objective and measurable standards.

Similarly, the proposed rule would require an Enterprise to utilize its counterparty risk management framework to assign each counterparty a rating of "not high" or "high" to reflect the counterparty's concentration in mortgage credit risk. The Enterprises should be required to disclose the metrics for making such determinations of market concentration. Disclosure of these metrics would enable counterparties to make business adjustments that reduce risks to the Enterprises. In addition, the Enterprises should make it clear whether they are looking to only the contractually obligated counterparty, or to the entirety of the holding company structure when making that determination.

Finally, the proposed rule would require an Enterprise to determine whether a mortgage insurance counterparty is "approved" under the Enterprise's own private mortgage eligibility standards. We assume that this is intended, at least in most cases, to be a reference to approval under the Private Mortgage Insurer Eligibility Requirements (PMIERS) requirements adopted by an Enterprise. However, the proposed rule does not reference PMIERS. We recommend that the proposed rule be modified to clarify that approval is tied to the PMIERS requirements, where applicable. Since the Enterprises are free to waive portions of the PMIERS, it should also be made clear what the minimum standard is with regards to the enforced portions of the PMIERS.

F. Some Single-Family Risk Multipliers Should be Adjusted.

The proposed rule would require an Enterprise to adjust the base risk-weight for mortgage exposures to account for additional loan characteristics using a set of risk multipliers. For single family mortgages, these multipliers are set forth on Table 14 in the preamble to the proposed rule, and include factors such as loan purpose, occupancy, and property type.³¹ As described below, we believe that some of the proposed multipliers should be adjusted.

³¹ 85 Fed. Reg. 39309 (June 30, 2020).

We also are concerned about the cumulative impact of the multipliers on some mortgage loans. It is possible that the addition of several multipliers to some types of loans could result in a capital requirement that is excessive and that discourages the production of such loans. Before finalizing the proposed rule, we encourage FHFA to model the application of the multipliers to various loan products to avoid excessive capital charges that may unduly diminish the availability of such loans. An overall cap on the multipliers, like the one proposed in the 2018 rule, would help to mitigate this potential.

HPC recommends that the risk multiplier for TPOs should be adjusted based upon an assessment of the TPO.

The risk multiplier for loans originated by third-party originators (TPOs) treats all TPOs the same, which is not the case. Some lenders and aggregators subject mortgages originated by TPOs to significant due diligence reviews before sale to the Enterprises. This reduces risk for the Enterprises and should be reflected in the risk multipliers. We recommend that the risk multiplier for TPOs incorporate an assessment of the quality of the operations of both the TPO and the lender that delivers those TPO loans, much like the counterparty risk adjustment proposed for mortgage insurers. In other words, lenders with TPO oversight practices that receive a better rating under such an assessment would be subject to a more favorable risk multiplier because their due diligence practices reduce risk to the Enterprises.

HPC recommends that FHFA reconsider the use of the multiplier based upon refreshed credit scores for RPLs and NPLs.

Re-performing loan and nonperforming loans would be subject to a multiplier based upon refreshed credit scores. We are concerned that this multiplier could have the unintended effect of limiting mortgage loans to certain categories of borrowers, especially low-and-moderate-income borrowers and those with low FICO scores. Consider a borrower who experiences a significant drop in a credit score based upon some financial difficulty. That borrower naturally may seek a loan modification. This multiplier would impose a significant increase in the capital charge for that mortgage, beyond that associated with it being a non-performing loan. As a result, the Enterprise may find it in their interest to push the loan through foreclosure rather than attempt a loan modification. We recommend that FHFA reconsider the use of this multiplier and its potential impact on borrowers.

G. The Credit Enhancement Multiplier for MI Should be Modified.

HPC recommends that FHFA modify the credit enhancement multiplier to permit the Enterprises to add deeper MI in the future.

The proposed credit enhancement multiplier for single-family mortgages subject to mortgage insurance would vary based on the mortgage insurance coverage and loan characteristics, including whether the mortgage insurance coverage is charter-level or guide-level. As general rule, the multipliers for guide-level coverage are lower than the

multipliers for charter-level coverage. However, the rule provides that if the coverage percent of the mortgage insurance is greater than guide-level coverage, the credit enhancement multiplier is determined as if the coverage percent were guide-level coverage. This limitation serves as a disincentive for deeper mortgage insurance coverage. HPC recommends that FHFA modify this requirement to permit the Enterprises to explore the use of deeper MI as part of their risk sharing toolkit, which could serve to reduce risk.

The MI multiplier on seasoned loans with cancellable MI appears too conservative.

The mortgage insurance credit enhancement multiplier on seasoned loans with cancellable mortgage insurance seems too conservative. As an example, a prototypical loan with mortgage insurance – a loan with a 720-739 borrower credit score, 90 to 95 percent original loan-to-value – that has seasoned 48 to 60 months would have a capital charge equivalent to a loan without mortgage insurance that had amortized to an 85 to 90 percent LTV.

After 60 months, a loan that started with a 95 percent LTV would have amortized down to about 86 percent. That means the capital rule gives virtually no credit for the existence of mortgage insurance protection on the seasoned loan (since MI coverage reduces the effective LTV to the Enterprises to well below 86 percent). It is not reasonable to assume that all mortgage insurance on such loans would be cancelled after five years, so the result that mortgage insurance has virtually no capital value at that point seems at odds with the economic reality. We are unaware of an empirical basis for believing the credit performance of a highly seasoned loan with mortgage insurance should require more capital than a loan with similar seasoning and LTV but no mortgage insurance. Thus, we recommend that FHFA realign the credit enhancement multipliers to reflect the continued benefit from MI on seasoned loans.

H. The Cross-Guarantee Provision Double-Counts Capital and Would Harm UMBS.

HPC recommends restoring the 2018 proposal's 0 percent risk-weight on MBS guaranteed by an Enterprise.

The proposed rule would assign a 20 percent risk-weight to UMBS guaranteed by one Enterprise but held by the other. A non-zero risk-weight effectively requires FHFA-regulated capital be held two places for the same risk. That is, the proposal would result in a double capital charge on the securities underlying the UMBS as each Enterprise would be required to record a charge not only for its own exposure, but also for the exposure of the other Enterprise, which already would have taken a charge for that exposure, thus increasing capital beyond both Enterprises' aggregate total credit risk.

If the capital rule works as designed, this means that each Enterprise is appropriately capitalized in relation to its risks, and thus there is no need for the Enterprises to hold capital for the risks that the other poses, as it is simply duplicative of risks already accounted for. The 20 percent risk-weight will result in higher capital costs for the Enterprises, which would incentivize higher guarantee fees and lower returns on

UMBS, both of which will lead to higher costs for homebuyers. Despite these higher costs for market participants, there does not appear to be a corresponding risk reduction to the overall housing finance system.

HPC is concerned this approach would lead to bifurcated treatment of UMBS, thereby eroding the very liquidity and fungibility FHFA sought to achieve in creating UMBS in the first place. Additionally, because the Enterprises are some of the largest investors in the UMBS market, this proposal would potentially discourage them from purchasing UMBS issued by the other Enterprise, thus potentially destabilizing the UMBS market. If this policy is made retroactive to UMBS purchases already made, then the damage to the UMBS market could be even greater as both Enterprises would be incentivized to sell UMBS issued by the other Enterprise. The decreased liquidity to the UMBS market would be borne by all market participants, but most importantly would also ultimately lead to higher mortgage rates for individual borrowers.

For these reasons, HPC recommends eliminating the 20 percent risk-weight for commingled securities, and instead adopting the 2018 proposal's approach which would have assigned a zero percent credit risk capital requirement for an MBS guaranteed by the other Enterprise.

I. Greater Transparency on Operational Risk Charge is Needed.

HPC recommends that FHFA provide more transparency on the basis for the operational risk charge.

The proposed rule would establish an operational risk capital requirement to be calculated using the advanced measurement approach of the U.S. banking framework, but with a floor set at 15 basis points of adjusted total assets. Since this calculation would be based upon each Enterprise's own models, it is not clear what the charge may be if those models change. HPC recommends that FHFA provide more transparency on the basis for the operational risk charge.

J. Prudential Liquidity Standards are Unknown but are a Critical Counterpart to Capital Rules

Based on recent securities filings by the Enterprises, it appears that FHFA changed the prudential liquidity rules governing Enterprise liquidity management. Prudential liquidity rules go hand-in-hand with prudential capital requirements in establishing a safety and soundness framework for regulated financial institutions. HPC does not understand why FHFA has not been more transparent regarding changes to the Enterprises' prudential liquidity standards. It would have been helpful when evaluating the proposed capital framework to have greater insight into FHFA's thinking about liquidity requirements.

III. Conclusion

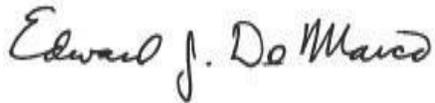
The Housing Policy Council and its members appreciate the effort that FHFA has put into preparing this revised capital proposal. We also appreciate the effort to incorporate comments submitted in response to the 2018 proposal.

In general, we find the structure advanced in this new proposal to be appropriate. Capital arbitrage across regulatory regimes was a fatal hallmark of the pre-conservatorship regulatory regime. We endorse the Treasury Department view that like risks should receive like capital treatment. This proposal is an improvement over the 2018 proposal with respect to accomplishing that goal.

As explained in this letter, several adjustments would make a considerable difference in moving further to achieve the capital alignment recommended by the Treasury Department. Most critically, the Housing Policy Council urges FHFA to reconsider the treatment of credit risk transfer, the use of adjusted total assets in the capital buffers, and the size of the leverage capital buffer.

We would be pleased to discuss any of these comments in further detail.

Yours truly,

A handwritten signature in black ink that reads "Edward J. DeMarco". The signature is written in a cursive, slightly slanted style.

Edward J. DeMarco
President
Housing Policy Council

Appendix A

Calibrating Enterprise Leverage Ratio for Single-Family Mortgage Risk

The proposed rule includes a minimum leverage ratio based on adjusted assets of 4 percent (2.5 percent minimum + 1.5 percent buffer). This Appendix outlines how the proposed leverage requirement is excessive relative to the primary risks assumed by the Enterprises. It also demonstrates that HPC's proposed 3 percent minimum leverage ratio is at the higher end of what would be implied by a conservative leverage ratio calibration.

Enterprise capital requirements are predominantly driven by the guarantee of single-family credit risk. To evaluate the appropriateness of a 4 percent leverage ratio relative to estimated credit risk in a highly stressed economic environment, we used publicly available data from Fannie Mae's Single-Family Loan Performance Dataset as of December 2018. Based on standard sampling techniques, we replicated Fannie Mae's aggregate single-family exposures consistent with the guidelines for loan inclusion in the dataset. We used a credit model developed by an HPC member specifically designed to evaluate Agency mortgage credit risk to calculate expected losses and stress case losses. The first set of stressed losses shown in Tables 1 and 2 are defined as the actual loss performance on similar loans following the 2008 crisis. In the same tables, we separately show modeled losses based on a future severe economic downturn.

We recognize that a point-in-time stress test is insufficient to baseline a leverage ratio because books of business can change over time. Yet, given all of the guardrails created by the mortgage reforms codified in the Dodd-Frank Act, seeing the proposed leverage ratio in light of the 2008 loss experience based on current books of business puts the proposed leverage requirements in proper focus. Thus, we offer this analysis because we think it demonstrates in a meaningful way why the proposed leverage ratio plus the leverage buffer is excessive.

Table 1 compares estimated single-family *lifetime* credit losses to Fannie Mae's minimum leverage capital requirements for the Single-Family Business. For example, modeled single-family credit losses before CRT risk sharing payments (but net of mortgage insurance claims payments) are estimated to be \$37.7 billion based on the performance of similar loans following the 2008 crisis. In a modeled hypothetical severe adverse economic scenario, estimated pre-tax losses are \$45.2 billion. These loss totals are inclusive of \$6.4 billion of *expected* credit losses that should not conceptually require any allocated capital. We separately attempt to adjust for the estimated impact of CRT coverage by combining information on total CRT outstanding as disclosed by Fannie Mae as of September 30, 2019, and an estimate of CRT's effective share of unexpected stress losses on the covered pools. Based upon this analysis, we estimate that CRT would reduce unexpected lifetime credit losses in these scenarios by between \$9.8 billion and \$12.1 billion.

Excluding the benefits of CRT, the Tier 1 leverage ratio of 4 percent proposed in the rule for the Single-Family Business would imply that leverage capital covers 314 to 390

percent of stress lifetime pretax credit losses. Including the net benefit of CRT, leverage capital coverage increases to 457 percent to 567 percent of pretax losses. Notably, unlike bank stress tests, in addition to assuming lifetime losses are recognized immediately, the figures in Table 1 *do not* reflect any offsetting benefit to the Enterprises from accumulated net revenues before credit provisions. Therefore, to the extent that capital plus pre-provision earnings are expected to provide loss absorbing capacity, a 4 percent leverage ratio implies a level of capital redundancy that is too high and economically inefficient.

Table 1: Illustration of Capital Coverage of Single-Family Credit Losses for Fannie Mae as of September 30, 2019 (\$ billions)

Illustration of Capital Coverage of Single-Family Credit Losses (Fannie Mae, \$ billions)							
Based on 9/30/2019 balance sheet							
Fannie Mae Single-Family Guaranty Book	2,971						
Tax rate	21%						
Single Family % Capital	86%						
Single Family RWA before CRT benefit	890						
Minimum Tier 1 leverage capital 2020 rule*	121.8						
Minimum CET1 2020 rule*	94.0						
Share of guaranty book UPB covered by CRT	42.1%						
Estimated CRT coverage of stress case losses	74.2%						
	Lifetime estimated expected loss rate	Without CRT			With CRT**		
		Stressed losses, severe adverse case	Stressed losses, 2008 crisis repeat	2019 DFAST results credit provision***	Stressed losses, severe adverse case	Stressed losses, 2008 crisis repeat	2019 DFAST results credit provision***
\$ billions							
Losses % UPB	0.21%	1.52%	1.27%	0.88%	1.52%	1.27%	0.88%
Total losses, gross	6.4	45.2	37.7		45.2	37.7	
Unexpected net losses, pretax		38.8	31.3	26.0	26.7	21.5	17.9
Unexpected net losses, after tax		30.6	24.7	20.5	21.1	17.0	14.1
Tier 1 FHFA Base % Pretax Total Losses		314%	390%	469%	457%	567%	682%
Tier 1 FHFA Base % After-tax Total Losses		398%	493%	593%	579%	718%	863%
CET1 FHFA % Pretax Total Losses		242%	301%	362%	353%	437%	526%
CET1 FHFA % After-tax Total Losses		307%	380%	458%	446%	554%	666%
Remaining Tier 1 net of pretax losses		83.0	90.6	95.8	95.2	100.3	104.0
<i>Trough Tier 1 % guaranty book</i>		2.80%	3.05%	3.23%	3.20%	3.38%	3.50%
Remaining CET1 net of pretax losses		55.2	62.7	68.0	67.3	72.5	76.1
<i>Trough CET1 % gross RWA</i>		6.20%	7.05%	7.64%	7.56%	8.14%	8.55%
Remaining Tier 1 net of after-tax losses		91.2	97.1	101.3	100.8	104.9	107.7
<i>Trough Tier 1 % guaranty book</i>		3.07%	3.27%	3.41%	3.39%	3.53%	3.63%
Remaining CET1 net of after-tax losses		63.4	69.3	73.5	72.9	77.0	79.9
<i>Trough CET1 % gross RWA</i>		7.12%	7.78%	8.25%	8.19%	8.65%	8.97%

* Capital attributable to Single-Family Business only, which is 86% of total risk-based capital as of 9/30/2019.
** We assume CRT provides pro rata coverage of losses, which is arguably conservative since CRT is issued to cover loans that are higher risk.
*** Includes both Single Family and Multifamily Provisions (https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2019_DFAST_Severely-Adverse-Scenario.pdf)

What is an appropriate leverage requirement if the proposed rule is excessive relative to the underlying risks? In the absence of a well-defined multiplier of losses, we looked to the Federal Reserve’s requirements for CCAR banks to maintain a post-stress 4.50 percent minimum unadjusted CET1 ratio. This is a widely accepted calibration of going concern capital levels. To reiterate, our proposed standard is more conservative than

the Federal Reserve's since it provides no offsetting benefit from pre-provision net revenues and assumes full recognition of lifetime losses.

As shown in Table 2, the implied *initial* leverage ratio consistent with this trough level of 4.5 percent CET1 implies a 2.5 to 3.0 percent leverage requirement, compared to the 4 percent proposed in the rule. Even at these modified levels, leverage capital would cover 306 percent to 404 percent of pretax lifetime credit losses. We believe this coverage ensures that the Enterprises would remain going concerns in the eyes of relevant stakeholders.

Table 2: Illustration of Minimum Capital Levels Using CET1 Target of 4.5 Percent After Single-Family Credit Losses – Fannie Mae data as of September 30, 2019 (\$ billions)

	Without CRT				With CRT**			
	Lifetime estimated expected loss rate	Stressed losses, severe adverse case	Stressed losses, 2008 crisis repeat	2019 DFAST results credit provision***	Stressed losses, severe adverse case	Stressed losses, 2008 crisis repeat	2019 DFAST results credit provision***	
\$ billions								
Losses % UPB	0.21%	1.52%	1.27%	0.88%	1.52%	1.27%	0.88%	
Total losses, gross	6.4	45.2	37.7		45.2	37.7		
Unexpected net losses, pretax		38.8	31.3	26.0	26.7	21.5	17.9	
Unexpected net losses, after tax		30.6	24.7	20.5	21.1	17.0	14.1	
Calibrated spot minimum capital levels for stress unexpected losses (9/30/2019)								
3Q19 CET1 minimum if target 4.50% immediate stress*		70.7	64.8	60.6	61.1	57.0	54.2	
CET1 % gross RWA before impact of CRT		7.9%	7.3%	6.8%	6.9%	6.4%	6.1%	
Change vs. 2020 rule		-24.8%	-31.1%	-35.5%	-35.0%	-39.3%	-42.4%	
Implied non-CET1 Tier1**		23.6	21.6	20.2	20.4	19.0	18.1	
Implied Total Tier 1 Capital (CET1 + non-CET1)		94.3	86.4	80.8	81.5	76.1	72.2	
Initial required Tier 1 % guaranty book		3.2%	2.9%	2.7%	2.7%	2.6%	2.4%	
Change vs. 2020 rule		-22.6%	-29.1%	-33.7%	-33.1%	-37.6%	-40.7%	
Tier 1 coverage of pre-tax unexpected credit losses (%)		243.0%	276.1%	310.8%	305.7%	353.9%	404.3%	

* Defined as: Starting level of capital required to ensure a minimum risk-based 4.5% CET1 ratio after stressed lifetime losses are incurred.

** Assumes Enterprise will have 25% non-CET1 in its Tier 1 capital stack, consistent with 4.5% CET1 and 6.0% Tier 1 minimum requirements.

Appendix B

Examples of Pre-Financial Crisis CRT Deals

In the years prior to the 2008 global financial crisis, at least seven different issuers completed at least 31 separate risk transfer transactions on U.S. real estate mortgage risk. These transactions covered \$342 billion notional UPB and transferred over \$9 billion³² of credit risk. These structures were utilized by a wide variety of financial institutions including banks, mortgage insurers, and a farm credit system member.

Given the depth and breadth of the financial crisis, it is safe to describe these transactions as legally tested through a worst-case scenario where many other financial transactions involving mortgage credit risk ended with dispute and often unresolved litigation. The risk holders on these portfolios (bond buyers) absorbed over \$2 billion of credit losses.

Representative transactions include:

Banks:

Bank of America, N.A.: Real Estate Synthetic Investment Finance (RESIF) 19 transactions, \$322.9 billion original notional UPB

E*Trade Bank: EASI Finance (EASI) 1 transaction, \$4.0 billion original notional UPB

Sovereign Bank: Sovereign Asset Synthetic Investment Securities (SASIF) 1 transaction, \$5.2 billion original notional UPB

Mortgage Insurance:

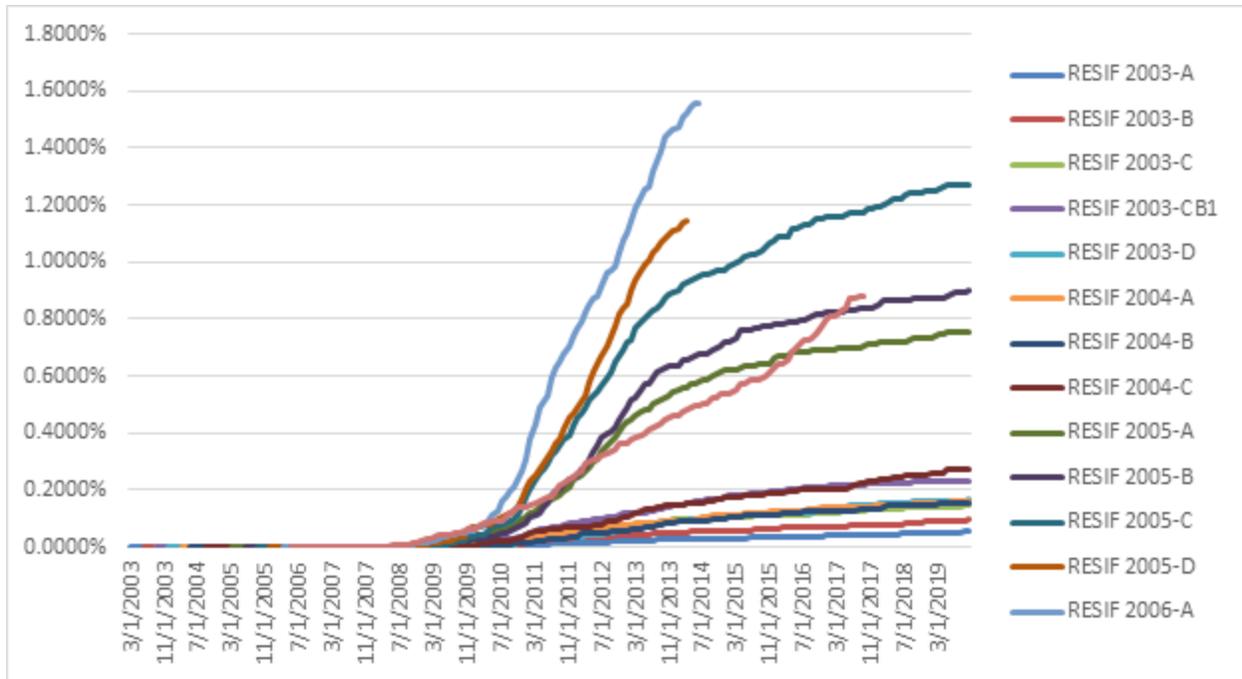
Radian Group: Smart Home Reinsurance Limited (SHOME) 4 transactions, approximately \$2.6 billion original notional UPB

MGIC Investment Corporation: HOME Re Limited (HOMRE) 3 transactions, approximately \$6.1 billion original notional UPB

Farm Credit System Member:

Northwest Farm Credit Services: Mt. Spokane Trust (MTSPO) 3 transactions, approximately \$1.5 billion original notional UPB

³² Source: Bloomberg L.P. & Intex Solutions



The RESIF program (the largest and most comparable to GSE programs) covered significant losses after the 2008 financial crisis – the chart above shows the cumulative loss percentages (based on original loan balance) by deal/vintage. As the chart highlights, less seasoned deals generated significant losses almost immediately – highlighting the benefits of forward starting protection. While the more seasoned deals did not avoid losses, they were spared the significant losses on the less seasoned deals. In all deals, all of these losses (minus what was retained by the buyer of protection – Bank of America, N.A.) were covered by the credit protection.

Appendix C

The Economics of Credit Risk Transfer: FHFA's proposed rule creates disincentives for CRT usage under the proposed capital rule; adjustments to the framework would better align economics and policy objectives

One of the objectives of the proposed rule is to increase the quality and quantity of regulatory capital held by the Enterprises. To that end, the rule distinguishes between different forms of capital. In doing so, the rule gives insufficient credit to credit risk transfer (CRT) as a form of loss-absorbing capital.

In this Appendix, we show the arithmetic implications of the rule and the resulting disincentives for single-family risk distribution through the use of CRT. This analysis supports the recommendations in the body of our comment letter to alter the proposed rule.³³

In the proposed rule, a meaningful reduction (increase) in the riskiness of guaranteed mortgages does not produce a proportionate adjustment in capital requirements because the proposed capital buffers are not risk-based.

The proposed rule's prescribed capital conservation buffer amount (PCCBA) materially blunts the impact of either increases or decreases in the net credit risk assumed (as proxied by asset-level risk-weights) by the Enterprises per dollar of notional credit exposure. We use Fannie Mae's capital requirements to illustrate this impact. The proposal implies that, prior to adjustments for CRT but inclusive of primary mortgage insurance, Fannie Mae held total risk-weighted asset equivalents (RWAs) of \$1,145 billion on September 30, 2019 (Table 1).

Changes in RWA density from these base levels, assuming a static balance sheet and a stable credit environment, would primarily be driven by: (1) the mix of loans held; and (2) the distribution of risk through CRT or similar mechanisms. All else equal, an increase in riskiness of loans would increase RWAs, while issuance of CRT would decrease RWAs.

However, as illustrated in Table 1 (and momentarily ignoring leverage requirements), changes in CET1 requirements reflect less than half of the change in measured risk. For example, steps taken by Fannie Mae to reduce effective credit risk exposure by half would reduce CET1 requirements by only 22 percent. Conversely, a 50 percent increase in risk would require only 22 percent additional equity capital. This outcome is a function of having the majority of risk-based capital requirements, specifically

³³ The calculations in this appendix were prepared by a nonbank HPC member that is a significant mortgage originator and servicer. The findings reported here corroborate those published in a research paper prepared by JP Morgan Chase Research. See "You break it, you own it", North America Securitized Products Research, https://markets.jpmorgan.com/research/email/-pa5128c/-V4_mSm4bGjC_eIcpEGSWw/GPS-3447310-0.

the PCCBA, tied to total adjusted assets rather than risk-weighted assets. Perversely, the minimum required CET1 ratio as calculated based on the traditional bank method (that is, capital divided by risk-weighted assets) would *decline* as balance sheet risk increases, which would seem to incentivize more risk taking and/or less risk shedding by the Enterprises.

Table 1: Illustration of Fannie Mae CET1 based on Risk-Weighted Asset Changes

\$ billions								
Fannie Mae Gross RWA before CRT	1,145							
Fannie Mae Adjusted Assets	3,547							
Fannie Mae RWA % of adjusted assets	32.3%							
		Illustrative RWA reduction (lower risk loans, CRT, etc.)						
Minimum capital requirements	Ratio	0.0%	-50.0%	-25.0%	-10.0%	10.0%	25.0%	50.0%
<i>Risk weighted assets (RWA)</i>		1,145	573	859	1,031	1,260	1,431	1,718
Common Equity Tier 1 (% RWA)	4.50%	51.5	25.8	38.6	46.4	56.7	64.4	77.3
Stress Capital Buffer (% adjusted assets)	0.75%	26.6	26.6	26.6	26.6	26.6	26.6	26.6
Stability Capital Buffer (% adjusted assets)	1.05%	37.2	37.2	37.2	37.2	37.2	37.2	37.2
Total minimum CET1		115.4	89.6	102.5	110.2	120.5	128.3	141.1
<i>Change in minimum CET1 relative to base</i>			-22.3%	-11.2%	-4.5%	4.5%	11.2%	22.3%
Imputed CET1 (as % of RWA):								
Base minimum		4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
Stress Capital Buffer		2.3%	4.6%	3.1%	2.6%	2.1%	1.9%	1.5%
Stability Capital Buffer		<u>3.3%</u>	<u>6.5%</u>	<u>4.3%</u>	<u>3.6%</u>	<u>3.0%</u>	<u>2.6%</u>	<u>2.2%</u>
Total Minimum CET1		10.1%	15.7%	11.9%	10.7%	9.6%	9.0%	8.2%

More specific to CRT, we refer to outputs from FHFA's accompanying CRT capital relief tool for the impact on RWAs³⁴. The generic CRT transaction used in the tool implies a 43 percent RWA reduction, after assuming full capital markets execution (full collateralization) and other simplifying assumptions. However, this resulting RWA reduction is only part of the capital equation for the Enterprises, as they also must solve for capital buffers and the leverage ratio.

In Table 2, we set up a stylized example of the full impact of executing a CRT transaction on required capital using the generic CRT example. We believe this is representative of the assessment likely to be undertaken by management of the Enterprises in deciding whether or not CRT is an economically viable risk mitigation tool. Clearly, the decision tree starts with the question of whether the cost of regulatory capital from using CRT is higher or lower than the cost of other capital sources, of which common equity (CET1) is the dominant form.

For this example, we assume base profitability of the Single-Family Business that is roughly in line with Fannie Mae's recent actual financial results. We also make reasonable, market-driven assumptions about the potential cost of different forms of capital for the

³⁴ <https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Publishes-Credit-Risk-Transfer-Tool.aspx>.

Enterprises outside of conservatorship; the size of a likely capital buffer management would apply above the regulatory minimums, and the approximate costs for CRT based on the existing books.

As shown in Table 2, CRT does in fact reduce CET1 requirements. However, the combination of risk-invariant capital buffers and haircuts on RWA relief built into the CRT formulas results in a very high mid-teens cost of capital for utilizing CRT. Since this is well above a reasonable cost of equity for a large, well-capitalized financial institution, it is highly unlikely that management teams would engage in CRT transactions. Indeed, it is not until the minimum risk-weight floor applied to senior risk (tranche AH) falls to very low levels that CRT becomes even a break-even proposition.

Table 2: Impact of Generic CRT Transaction on Fannie Mae Capital Requirements

\$ millions							
Loan UPB	1,000.0	Assumed pretax income ex CRT & TCCA % UPB*	0.55%				
CRT sold	38.0	Cost of CRT % reference UPB	0.15%				
Base loan risk weight	30.0%	Pretax income net CRT % UPB	0.40%				
Base RWAs	300.0	After-tax cost of common equity	10.0%				
RWA with CRT	171.1	After-tax cost of preferred equity	6.0%				
Detachment point as multiple of capital charge	166.7%	After-tax cost of subordinated debt	3.2%				
Cost of CRT (coupon spread)	4.00%						
Corporate tax rate	21.00%						

Required capital using framework in Capital Proposal		CRT based on assumed floor risk weight on AH tranche					
\$ millions	Ratio	No CRT	Proposal 10.0%	7.5%	5.0%	2.5%	0.0%
RWAs		300.0	171.1	147.2	123.3	99.4	75.6
Base CET1 (% RWA)	4.50%	13.5	7.7	6.6	5.5	4.5	3.4
PCCBA CET1 (% adjusted assets)	1.80%	18.0	18.0	18.0	18.0	18.0	18.0
Management operating buffer CET1 (% RWA)	1.50%	4.5	2.6	2.2	1.8	1.5	1.1
Other Tier 1 (% RWA)	1.50%	4.5	2.6	2.2	1.8	1.5	1.1
Other Capital (% RWA)	2.00%	6.0	3.4	2.9	2.5	2.0	1.5
Total risk-based capital required		46.5	34.3	32.0	29.7	27.4	25.2
<i>Total risk-based capital % RWA</i>		15.5%	20.0%	21.7%	24.1%	27.6%	33.3%
Total CET1 required under RBC		36.0	28.3	26.8	25.4	24.0	22.5
Reduction in CET1 from CRT			(7.7)	(9.2)	(10.6)	(12.0)	(13.5)
Implied after tax cost of CRT CET1 capital relief			15.5%	13.1%	11.3%	10.0%	8.9%

In terms of dollars of capital, Table 2 shows the limited capital relief granted by the proposed rule. Simply put, for this \$1 billion pool of loans, if the Enterprise did no CRT, it would be required to hold \$36 million of CET1 capital. After transferring all credit losses on between 0.5 percent of the pool's UPB and 4.5 percent of the UPB (a total of \$40 million of transferred loss exposure), the Enterprise would have required CET1 capital of \$28.3 million, which is only a \$7.7 million reduction in its CET1 capital requirement.

Combining the impact of the four percent minimum leverage ratio (with a likely management buffer) with the risk-based requirements, it becomes clear that CRT is costly and dilutive to return on equity under every scenario for minimum risk-weight floors (Table 3). Indeed, in our example, a CRT transaction that transfers the majority of credit risk to third-party holders would actually reduce Fannie Mae’s return on equity by over 200 basis points. This creates a clear disincentive for risk mitigation transactions. Furthermore, outside of conservatorship, shareholders of the Enterprises would likely punish management actions that materially dilute return on equity.

Table 3: Fannie Mae Return on Equity Impact from Generic CRT Transactions

<i>Required capital using framework in Capital Proposal</i>			<i>CRT based on assumed floor risk weight on AH tranche</i>					
<i>\$ millions</i>	<i>Ratio</i>	<i>No CRT</i>	<i>Proposal</i>	<i>10.0%</i>	<i>7.5%</i>	<i>5.0%</i>	<i>2.5%</i>	<i>0.0%</i>
<i>RWAs</i>		300.0	171.1	147.2	123.3	99.4	75.6	
Total risk-based capital required		46.5	34.3	32.0	29.7	27.4	25.2	
<i>Total risk-based capital % RWA</i>		15.5%	20.0%	21.7%	24.1%	27.6%	33.3%	
Total CET1 required under RBC		36.0	28.3	26.8	25.4	24.0	22.5	
Total leverage capital (% adjusted assets)	4.00%	40.0	40.0	40.0	40.0	40.0	40.0	40.0
Management operating buffer	0.50%	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Total adjusted leverage (% adjusted assets)	4.50%	45.0	45.0	45.0	45.0	45.0	45.0	45.0
Effective minimum Tier 1 capital		45.0	45.0	45.0	45.0	45.0	45.0	45.0
Implied minimum CET1 (RBC or leverage)		36.0	28.3	26.8	25.4	24.0	22.5	
Implied minimum preferred equity		9.0	16.7	18.2	19.6	21.0	22.5	
Implied minimum subordinated debt (Tier 2)		1.5	-	-	-	-	-	
Implied Tier 1 WACC		9.2%	8.5%	8.4%	8.3%	8.1%	8.0%	
Fannie return on Tier 1 capital (ex TCCA)		9.6%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%
<i>Excess/(shortfall) vs. Tier 1 WACC</i>		0.4%	-1.5%	-1.4%	-1.3%	-1.1%	-1.0%	
Fannie return on CET1 (ex TCCA)		10.5%	7.6%	7.7%	7.7%	7.9%	8.0%	
<i>Return on CET1 Excess/(shortfall) vs. cost of equity</i>		0.5%	-2.4%	-2.3%	-2.3%	-2.1%	-2.0%	

We appreciate that solving for all these issues simultaneously is challenging. However, we believe an important guiding principle for the proposed rule should be, at the very least, to not create economic disincentives for the Enterprises to utilize CRT for risk management. Even if there is a modest but quite desirable goal to at least equilibrate the cost of CRT with the cost of common equity, it will require a recalibration of the minimum leverage ratio, a switch to truly risk-based CET1 buffers, and a reduction in, or elimination of, the AH tranche risk-weight floor.

In Table 4, we illustrate the return on equity math from a recalibration of all three of these metrics using the stylized CRT example outlined above. To ensure a healthy level of CET1 in the capital structure, we apply a requirement that CET1 must be at least a

minimum percentage of total Tier 1 capital. Using minimum capital buffers for Bank of America Corp., an institution with arguably similar domestic systemic importance as Fannie Mae, would suggest a combined risk-based CET1 buffer requirement of 5 percent of risk-weighted assets. This would replace the current risk-insensitive buffers. The result of this reformulation is that minimum CET1 is defined as the greater of 9.5 percent of risk-weighted assets or 65 percent of the leverage capital requirement.

If we define a “do no harm” principle as those scenarios where CRT is not materially dilutive to return on equity, the breakeven leverage ratio (with a buffer) is between 2.5 percent and 3.0 percent, assuming we set a CET1 floor at 65 percent of total minimum Tier 1 leverage capital. The leverage ratio would start to become more binding as the minimum CRT tranche risk-weight floor drops. Notably, in this formulation, CET1 risk-based ratios remain at robust levels. Given that estimated capital at these levels would still cover stressed credit losses several times over (see the discussion of stress losses in Appendix A), a recalibration of these three aspects of the rule to support appropriate CRT incentives would not impact the safety and soundness of the Enterprises.

Table 4: ROE Impact from CRT with Illustrative Recalibration of Capital Rule

\$ millions	RWA buffers, 50% minimum CET1 as % Tier 1				RWA buffers, 65% minimum CET1 as % Tier 1			
	No CRT	10% AH	5% AH	0% AH	No CRT	10% AH	5% AH	0% AH
<i>With 2.50% minimum leverage ratio:</i>								
Minimum CET1	33.0	18.8	13.6	12.5	33.0	18.8	16.3	16.3
Fannie return on CET1 (ex TCCA)	11.9%	13.1%	15.9%	16.8%	11.9%	13.1%	14.3%	14.3%
<i>With 3.00% minimum leverage ratio:</i>								
Minimum CET1	33.0	18.8	15.0	15.0	33.0	19.5	19.5	19.5
Fannie return on CET1 (ex TCCA)	11.9%	11.5%	13.0%	13.0%	11.9%	11.4%	11.4%	11.4%
<i>With 3.50% minimum leverage ratio:</i>								
Minimum CET1	33.0	18.8	17.5	17.5	33.0	22.8	22.8	22.8
Fannie return on CET1 (ex TCCA)	11.6%	10.0%	10.3%	10.3%	11.6%	9.3%	9.3%	9.3%
<i>With 4.00% minimum leverage ratio:</i>								
Minimum CET1	33.0	20.0	20.0	20.0	33.0	26.0	26.0	26.0
Fannie return on CET1 (ex TCCA)	11.0%	8.2%	8.2%	8.2%	11.0%	7.7%	7.7%	7.7%

Appendix D

Lender Risk Share Transactions Reduce Enterprise Risk and Align Incentives

In this Appendix, we explain lender risk-share transactions and how they align the interests of lenders and the Enterprises and can reduce risk for the Enterprises and taxpayers.

CRT transactions may be structured as “back-end” or “front-end” transactions.

Most CRT transactions are “back-end,” which means that Fannie Mae or Freddie Mac acquires a pool of mortgages and subsequently issues a CRT bond, a multi tranche security, or enters into an insurance contract to transfer some portion of the mortgage credit risk to a third party. Usually, the risk transferred is not the so-called “first dollar” or “expected losses,” which the Enterprises typically retain, but the unexpected losses. Moreover, in these back-end transactions, the Enterprises control the entire process. They select the timing for the transaction, the transaction structure, the counterparties, the deal terms, and the loans to be covered. The CRT counterparties rely upon the Enterprises to carry out the terms of the transaction, including all oversight and management of the servicing, but typically have little other recourse.

The Enterprises also have engaged in lender risk-share CRT where the lender arranges the CRT at the front-end – before or at the time of selling a loan pool to an Enterprise. Front-end CRT structures are like the back-end transactions used by the Enterprises, except it is the lender that retains a credit risk position in the pool of mortgages, not an Enterprise, and it is the lender that is responsible for the servicing.

HPC strongly believes that front-end lender risk share CRT should be a core element of risk transfer with Enterprise-backed MBS. It directly contributes to the broader distribution of credit risk in our financial system. It also aligns the lender’s and the Enterprise’s interest in the performance and sound servicing of the loans.

Another important feature of lender risk share CRT is that it expands the channels for distributing risk from the Enterprises to private investors and expands the pools of private capital capable of investing. This reduces the overall systemic risk posed by the Enterprises.

Lender risk share CRT aligns the lenders’ interests with those of the Enterprise.

When the lender originates a set of mortgages that it will credit enhance through a front-end CRT, it knows it will share in the credit risk on these loans. That creates a powerful interest to ensure the quality of the loan underwriting process, which includes verifying a borrower’s income and assets and assuring the borrower’s ability to repay. In typical loan sales from lenders to an Enterprise, the lender has a contractual obligation to ensure sound loan underwriting but does not typically retain a residual interest in the

actual credit performance of the loan. Once a loan is sold, all that risk shifts to the Enterprise.

Interestingly, a key provision of the Dodd-Frank Act requires risk retention in asset-backed securitization. Congress included this requirement to ensure that lenders had a financial stake (“skin-in-the-game”) in the performance of the securitized loans. Since the Enterprises securitize mortgages, not the lenders, this risk retention requirement falls to the Enterprise even though it had nothing to do with the loan origination. Lender risk share CRT aligns the risk retention requirements applicable to the Enterprises with the interest of a lender because the lender retains risk exposure to the credit performance of the loan.

More than that, the lender also retains responsibility for the loan servicing. Again, this aligns interests. The servicer wants to ensure servicing troubled loans is carried out in a manner that reduces losses because they share in those losses. In normal servicing of Enterprise loans, the servicer does not have a credit exposure on the loans.

In sum, front-end lender risk share CRT creates a tight alignment of interest between the lender and the Enterprise because the lender has a direct and ongoing financial exposure to the credit performance of the loan throughout the life of the loan.

Lender risk share CRT reduces risk for the Enterprises and taxpayers.

Front-end lender risk share CRT reduces risk for the Enterprises and taxpayers in several key respects. First, it shifts the funding risk during the period in which loan pools are assembled for securitization from the Enterprises to the lender. Back-end CRT requires an Enterprise to hold all of the credit risk on the mortgages it purchases until it can execute a CRT transaction, which typically can take between three to five months. In a front-end lender risk share CRT, the lender must cover this risk. Front-end CRT requires the lender to have the capital up front, as it begins the loan aggregation process, and to retain that risk until the loans are sold to the Enterprise.

Second, front-end lender risk share CRT eliminates the liquidity risk associated with CRT transactions in periods of economic stress. This is a risk that we witnessed earlier this year at the outset of the COVID-19 pandemic. At that time, CRT market volatility led to a temporary suspension of the CRT market. As a result, the Enterprises were forced to retain all of the risk on purchased mortgages until the markets returned to normal. In front-end deals, that risk to the Enterprises does not exist.

Third, front-end lender risk share CRT reduces risk to the Enterprises because the lender is in a true “first loss” position. In back-end CRT, the Enterprises retain all the exposure to initial (i.e., expected) losses, typically ranging from the first 10 to 25 basis points of the unpaid principal balance on the loan pool. In lender risk share CRT, every dollar of loss from the first dollar is absorbed by the lender, up to the coverage level of the CRT (typically the same as with back-end CRT, leaving the Enterprise just with the very tail end of loss exposure).

Finally, lenders that regularly engage in front-end CRT need to ensure they manage their own execution risk as they manage their loan production pipeline. That means they have to ensure they maintain a forward trade with their risk sharing partners so that the capital is raised and allocated before the loan is produced. This adds stability to the CRT program through economic and housing cycles.

The following table summarizes how the characteristics of front-end lender risk share CRT align with FHFA’s principles for CRT.³⁵

Alignment of Front-end CRT to FHFA’s CRT Principles

✓ Reduce taxpayer risk	Lender takes first loss up to 4.0% - 5.0%, reducing taxpayer risk more than CAS/STACR in most scenarios
✓ Economically sensible	Risk sharing provides the GSEs with significant capital relief
✓ Continuity of core business	No impact to the TBA market
✓ Repeatable	Multiple lenders have done front-end CRT, at least one with a series of repeated transactions. To-date, the ability to do repeated transactions has been controlled by the Enterprises.
✓ Scalable	Each successive transaction has grown, with most recent deals being comparable in size to some CAS/STACR deals.
✓ Counterparty strength	Lenders (bank and nonbank) that have done front-end CRT have been well-capitalized, modestly levered, and have fully-collateralized the credit risk transactions
✓ Broad investor base	Lender risk share is one of the three primary structures in the GSEs’ portfolio of CRT programs
✓ Stability through economic and housing cycles	Front-end CRT has been done by very large, well-capitalized lenders that have dedicated billions of permanent equity capital to their mortgage activities. If allowed to develop, CRT would be at the core of their investment strategy
✓ Transparency	A differentiating feature of front-end CRT is that the public disclosures exceed those of the Enterprises.
✓ Level playing field	Spreads are market-based and reflect the cost of transferring risk

³⁵ 85 Fed. Reg. 39329 (June 30, 2020).

FHFA retains supervisory oversight in lender risk share CRT.

To be clear, HPC's recommendations in support of lender risk share CRT recognizes and affirms FHFA's authority to set the parameters for approving and monitoring the risk transfer structures for loans sold to the Enterprises. We believe that if FHFA has approved a structure for the Enterprises to use in transferring risk, such a structure should be available for other market participants. Simply put, whether a security structure or an insurance arrangement, we seek parity in regulatory treatment of the credit enhancement.

Moreover, FHFA's authority and oversight should extend to ensuring the protection of not just the Enterprises but also the integrity of the housing finance system and the stability of housing markets. This means that FHFA should monitor the pricing of front-end CRT to ensure that it is supportable and market-based, just as it would do with transactions carried out by the Enterprises.

Summary

Lender risk share CRT satisfies the Dodd-Frank Act's call for risk retention, lowers Enterprise (and taxpayer) risk, and aligns incentives for producing quality loans and servicing them responsibly. The only downside it produces for the Enterprises is that it introduces competition. However, since competition benefits consumers and reduces systemic risk and broadens "*the distribution of investment capital available for residential mortgage financing,*" as required by the Fannie Mae Charter Act, HPC urges FHFA to reconsider its opposition to front-end lender risk share CRT.

Appendix E

Responses to FHFA's Questions

Question 1. Is each of the definitions of CET1 capital, tier 1 capital, and tier capital appropriately formulated and tailored to the Enterprises?

HPC believes that the capital framework for the Enterprises should be aligned with the capital framework applicable to banks to the extent possible to discourage regulatory arbitrage. Using the definitions of capital from the banking capital framework is consistent with this approach. Common definitions of capital enable comparisons of the two frameworks. See Section 1. B. of our comment letter.

Question 2. Should FHFA include additional amounts of an Enterprise's ALLL or excess credit reserves in any of the components of regulatory capital?

Some banking institutions have recommended that, in connection with the imposition of the CECL accounting standard, the federal banking regulators permit some reserves to count toward regulatory capital. If the federal banking regulators make such a change, we believe that FHFA should make a similar adjustment to the capital rules applicable to the Enterprises.

Question 3. Should any other capital elements qualify as CET1 capital, additional tier 1 capital, or tier 2 capital elements?

We support consistency between these definitions and the definitions used in the bank capital rules.

Question 4. Is the tier 1 leverage ratio requirement appropriately sized to serve as a credible backstop to the risk-based capital requirements?

We believe that the minimum tier 1 leverage ratio at 2.5 percent is appropriate, but the proposed leverage buffer is too high. We recommend that the leverage buffer be reduced to 0.5 percent for a total leverage requirement of 3 percent. See Section II. A. and Appendix A in our comment letter.

Question 5. Should the Enterprise's leverage ratio requirements be based on total assets, as defined by GAAP, the Enterprise's adjusted total assets, or some other basis?

The proposal defines adjusted total assets to align with the denominator used in setting the supplemental leverage requirement for large banking institutions. This is consistent with our goal of alignment with banking capital rules, to the extent possible.

Question 6. Should FHFA consider any changes to its contemplated enforcement framework? What supervisory guidance would be helpful to promote market understanding of how FHFA expects to apply its enforcement authorities?

FHFA's Advisory Bulletin AB 2013-03 is a comprehensive summary of the agency's enforcement powers.

Question 7. Should any of the risk-based capital requirements or leverage ratio requirements be phased-in over a transition period?

Section 1240.4 of the proposed rule sets the compliance date for the capital requirements at the later of one year after publication of the final rule or the termination of the conservatorship, and it gives the Director authority to set a later compliance date based upon market conditions. These provisions should provide for a sufficient transition period.

Question 8. Alternatively, should the enforcement of the risk-based capital requirements during the implementation of a capital restoration plan be tailored through a consent order or other similar regulatory arrangement, and if so how?

No response.

Question 9. Is the stress capital buffer appropriately formulated and calibrated?

The 0.75 percent stress capital buffer does not seem unreasonable. However, we recommend that the stress capital buffer and the other capital buffers be based upon risk-weighted assets rather than adjusted total assets. See Section II. C. of our comment letter. Additionally, in Section II. D. of our letter, we note that the application of the stress capital buffer should address FHFA's concerns regarding the impact of market disruptions on CRT.

Question 10. Should an Enterprise's stress capital buffer be periodically re-sized to the extent that FHFA's eventual program for supervisory stress tests determines that an Enterprise's peak capital exhaustion under a severely adverse stress would exceed 0.75 percent of adjusted total assets?

As a general matter, we believe that FHFA should periodically assess, and adjust as necessary, the size of all of the capital buffers as long as predictable, metrics-driven methodology is articulated and made public. We also suggest FHFA provide some sort of minimum notice period for implementation, or public comment period, if appropriate.

Question 11. Should an Enterprise's stress capital buffer be adjusted as the average risk weight of its mortgage exposures and other exposures changes?

See our response to Question 9.

Question 12. Should an Enterprise's stress capital buffer be based on the Enterprise's adjusted total assets or risk-weighted assets?

Risk-weighted assets. See our response to Question 9.

Question 13. Is the countercyclical capital buffer appropriately formulated?

See Section II. C. of our letter. We recommend that FHFA make the operation of this buffer more predictable and aligned with its use in the bank regulatory framework. Furthermore, the buffer should include a phase-in period and time limitation consistent with those of the banking agencies. Also, as noted in our response to Question 9, we believe the buffer should be based upon risk-weighted assets rather than total adjusted assets.

Question 14. What administrative or other process should govern FHFA's adjustments to the countercyclical capital buffer?

FHFA is proposing to deploy the countercyclical capital buffer only when similar buffers are deployed by U.S. banking regulators. We agree with this approach. As we note in Section II. C of our letter, the buffer should include a phase-in period and time limitation consistent with those of the banking agencies.

Question 15. Should FHFA more explicitly base its determination to adjust the countercyclical capital buffer to the determination of the U.S. banking regulators to adjust their similar buffer?

See our response to Question 13 (also Section II. C. of our letter).

Question 16. Is the market share approach appropriately formulated and calibrated to mitigate the national housing finance market stability risk posed by an Enterprise? If not, what modifications should FHFA consider to ensure an appropriate calibration?

The market share approach to the stability buffer is not unreasonable.

Question 17. Is the market share approach appropriately formulated and calibrated to ensure each Enterprise operates in a safe and sound manner? If not, what modifications should FHFA consider to ensure an appropriate calibration?

As noted in our response to Question 9, we believe the capital charge should be based upon risk-weighted assets.

Question 18. Should the Enterprise-specific stability capital buffer be determined using the U.S. banking framework's approach to calculating capital surcharges for GSIBs?

We do not believe it is appropriate to apply the GSIB surcharge framework to the Enterprises. The GSIB surcharge calculation is designed to apply to heterogeneous bank business models. In contrast, the two Enterprises have the same basic monoline business model.

Question 19. What, if any, modifications to the U.S. banking framework's approach to calculating capital surcharges for GSIBs are appropriate for determining the Enterprise-specific stability capital buffer?

We think it is reasonable to size Enterprise stability capital buffers based in part on looking at the range applied to domestically focused, systemically important banks as a benchmark. However, in recognition of the material differences in business models between banks and the Enterprises, this should not be determinative. See our response to Question 18.

Question 20. Should the Enterprise-specific stability capital buffer be determined based on a sum of the weighted indicators for size, interconnectedness, and substitutability under the U.S. banking framework?

See our response to Question 18.

Question 21. Which, if any, indicators of the housing finance market stability risk posed by an Enterprise, other than its market share, should be used to size the Enterprise's stability capital buffer? How should those other indicators be measured and weighted to produce a score of the housing finance market stability risk posed by an Enterprise?

See our responses to Questions 16 and 18.

Question 22. What, if any, measure of the Enterprise's short-term debt funding or expected debt issuances during a financial stress to fund purchases of NPLs out of securitization pools should be used to size the Enterprise's stability capital buffer?

See our responses to Questions 16 and 18.

Question 23. Is the PLBA appropriately sized to backstop the PCCBA-adjusted risk-based capital requirements?

See our response to Question 4.

Question 24. Should the PLBA for an Enterprise be sized as a fraction or other function of the PCCBA of the Enterprise? If so, how should the PLBA of an Enterprise be calibrated based on the Enterprise's PCCBA?

See our response to Question 4.

Question 25. Are the payout restrictions appropriately formulated and calibrated?

Yes, as they are generally aligned with bank regulation.

Question 26. Should there be any sanction or consequence other than payout restrictions triggered by an Enterprise not maintaining a capital conservation buffer or leverage buffer in excess of the applicable PCCBA or PLBA?

No response.

Question 27. Should the payout restrictions be phased-in over an appropriate transition period? If so, what is an appropriate transition period?

No response.

Question 28. Should the payout restrictions provide exceptions for dividends on newly issued preferred stock, perhaps with any exceptions limited to some transition period following conservatorship?

No response.

Question 29. Should the payout restrictions provide an exception for some limited dividends on common stock over some transition period?

No response.

Question 30. Is the methodology used to calibrate the credit risk capital requirements for single-family mortgage exposures appropriate to ensure that the exposure is backed by capital sufficient to absorb the lifetime unexpected losses incurred on single-family mortgage exposures experiencing a shock to house prices similar to that observed during the 2008 financial crisis?

We find the risk-weights assigned to single-family mortgage exposures to be reasonable. We make specific recommendations for refinement in a few places. See Section II. B. of our letter.

Question 31. What, if any, changes should FHFA consider to the methodology for calibrating credit risk capital requirements for single-family mortgage exposures?

We recommend that FHFA recognize original loan-to-value ratios for a period of between 36 and 60 months after origination, not just six months. See Section II. B. of our letter.

Question 32. Are the base risk weights for single-family mortgage exposures appropriately formulated and calibrated to require credit risk capital sufficient to ensure each Enterprise operates in a safe and sound manner and is positioned to fulfill its statutory mission across the economic cycle?

See our response to Question 30.

Question 33. Are there any adjustments, simplifications, or other refinements that FHFA should consider for the base risk weights for single-family mortgage exposures?

See our response to Question 30.

Question 34. Should the base risk weight for a single-family mortgage exposure be assigned based on OLTV or MTMLTV of the single-family mortgage exposure, or perhaps on the LTV of the single-family mortgage exposure based on the original purchase price and after adjusting for any paydowns of the original principal balance?

As stated in our response to Question 31, we believe that the rule should recognize OLTV for a longer period after origination. See Section II. B. of our letter.

Question 35. Should the base risk weight for a single-family mortgage exposure be assigned based on the original credit score of the borrower or the refreshed credit score of the borrower?

We recommend the use of original credit scores in the grids. See Section II. B. of our letter.

Question 36. What steps, including any process for soliciting public comment on an ongoing basis, should FHFA take to ensure that the single-family grids and the real house price trend are updated from time to time as market conditions evolve?

Once the framework is in place, market participants would expect some level of continuity and consistency. At the same time, periodic review based upon changes in market conditions would be appropriate. A review every 5 years that includes public input may be reasonable. It will also be important for FHFA to keep the public informed of what house price indices it is relying upon as it examines real house price trends.

Question 37. Should a delinquency associated with a COVID-19-related forbearance cause a single-family mortgage exposure to become an NPL?

No, not so long as the loan is in a CARES Act forbearance.

Question 38. Which, if any, types of forbearances, payment plans, or modifications should be excluded from those that cause a single-family mortgage exposure to become a modified RPL? Should a forbearance, payment plan, or modification arising out of a COVID-19-related forbearance request cause a single-family mortgage exposure to become a modified RPL?

Generally, classification should take place at the time the post-forbearance accommodation is put in place, or the forbearance ends absent a further accommodation. Then, the loan should be classified as an RPL or some other classification based upon the post-forbearance accommodation. A COVID-19 loan that was in forbearance but was never delinquent should be treated as a performing loan.

Question 39. Is the MTMLTV adjustment appropriately formulated and calibrated to require credit risk capital sufficient to ensure each Enterprise operates in a safe and sound manner and is positioned to fulfill its statutory mission across the economic cycle? If not, what modifications should FHFA consider to ensure an appropriate formulation and calibration?

See our response to Question 31.

Question 40. Does the MTMLTV adjustment strike an appropriate balance in mitigating the pro-cyclicality of the aggregate risk-based capital requirements while preserving a mortgage risk-sensitive framework? Are the collars set appropriately at 5.0 percent above or below the long-term index trend?

See our response to Question 31.

Question 41. How should the long-term house price trend be determined for the purpose of any countercyclical adjustment to a single-family mortgage exposure's credit risk capital requirement?

We believe that the countercyclical adjustment be more granular and be based upon State level or MSA level housing prices. See Section II. B. of our letter.

Question 42. Are the risk multipliers for single-family mortgage exposures appropriately formulated and calibrated to require credit risk capital sufficient to ensure each Enterprise operates in a safe and sound manner and is positioned to fulfill its statutory mission across the economic cycle?

We recommend an adjustment to the risk multiplier related to third party originators and reconsideration of the multiplier for refreshed credit scores for RPLs and NPLs. Before finalizing the proposed rule, we encourage FHFA to model the application of the multipliers to various loan products to avoid excessive capital charges that may unduly diminish the availability of such loans. An overall cap on the multipliers, like the one proposed in the 2018 rule, would help to mitigate this potential. See Section II. F. of our letter.

Question 43. Are there any adjustments, simplifications, or other refinements that FHFA should consider for the risk multipliers for single-family mortgage exposures?

See our response to Question 42.

Question 44. Should the combined risk multiplier for a single-family mortgage exposure be subject to a cap (e.g., 3.0, as contemplated by the 2018 proposal)?

See our response to Question 42.

Question 45. Are the CE multipliers and CP haircut multipliers for single-family mortgage exposures appropriately formulated and calibrated to require credit risk capital sufficient to ensure each Enterprise operates in a safe and sound manner and is positioned to fulfill its statutory mission across the economic cycle?

We recommend that the inputs for the CP haircut be revised and that the criteria for rating counterparties be more transparent and objective. See Section II. E. of our letter.

We also recommend that the CE multiplier for seasoned loans with MI be modified. See Section II. G. of our letter.

Question 46. Are there any adjustments, simplifications, or other refinements that FHFA should consider for the CE multipliers and the CP haircut multipliers for single-family mortgage exposures?

See our response to Question 45.

Question 47. Are the differences between the proposed rule and the U.S. banking framework with respect to the credit risk mitigation benefit assigned to loan-level credit enhancement appropriate? Which, if any, specific aspects should be aligned?

See our response to Question 45.

Question 48. Is the minimum floor on the adjusted risk weight for a single-family mortgage exposure appropriately calibrated to mitigate model and related risks associated with the calibration of the underlying base risk weights and risk multipliers and to otherwise ensure each Enterprise operates in a safe and sound manner and is positioned to fulfill its statutory mission across the economic cycle?

The minimum floor is not unreasonable.

Question 49. Should the minimum floor on the adjusted risk weight for a single-family mortgage exposure be decreased or increased, perhaps to align the minimum floor with the more risk-sensitive standardized risk weights assigned to similar exposures under the Basel framework (e.g., 20 percent for a single-family residential mortgage loan with LTV at origination less than 50 percent)?

See our response to Question 48.

Question 50. Should the floor or other limit used to determine a single-family mortgage exposure's credit risk capital requirement be assessed against the base risk weight, the risk weight adjusted for the combined risk multipliers, or some other input used to determine that credit risk capital requirement?

It should be assessed against the base risk-weight unless there is an important policy goal to address by introducing this extra layer of complexity. See also our response to Question 48.

[Note: Questions 51-64 relate to multifamily lending and HPC has not addressed the treatment of multifamily lending in its comment letter.]

Question 65. What changes, if any, should FHFA consider to the operational criteria for CRT?

The operational criteria for CRT are not unreasonable.

Question 66. What changes, if any, should FHFA consider to the regulatory consequences of an Enterprise providing implicit support to a CRT?

We have no specific changes related to treatment of implicit support.

Question 67. Is the 10 percent prudential floor on the risk weight for a retained CRT exposure appropriately calibrated?

We recommend that this floor be eliminated or reduced on a sliding scale depending on the nature of the CRT structure. See Section II. D. of our letter, as well as Appendices B, C, and D.

Question 68. Should FHFA increase the prudential floor on the risk weight for a retained CRT exposure, for example so that it aligns with the 20 percent minimum risk weight under the U.S. banking framework?

No. We do not believe the bank framework is relevant to the Enterprises in this area. See also our response to Question 67.

Question 69. Should FHFA take a different approach to an Enterprise's existing CRT?

We believe in-place and future CRT should be treated the same outside of material differences in their structure or loss coverage, which presumably would already be captured in the structure of the rule. See Section II. D. of our letter and related Appendices.

Question 70. Is the proposed approach to determining the credit risk capital requirement for retained CRT exposures appropriately formulated?

No. We believe it is not appropriate and outline possible changes. See Section II. D. of our letter, and related Appendices.

Question 71. Are the adjustments for counterparty risk appropriately calibrated?

We have no objection to these adjustments, as long as the Enterprises are required to disclose their specific criteria for counterparty ratings.

Question 72. Are the adjustments for loss-timing and other maturity-related risk appropriately calibrated?

We have no objection to these adjustments.

Question 73. Is the 10 percent adjustment for the general effectiveness of CRT appropriately calibrated?

A general effectiveness adjustment is not unreasonable, but we believe HPC should periodically review whether 10 percent is too high or too low.

Question 74. Is the 10 percent adjustment for the general effectiveness of CRT appropriate in light of the proposed rule's prudential floor on the risk weight for retained CRT exposures?

See our response to Question 73.

Question 75. Should FHFA impose any restrictions on the collateral eligible to secure CRT that pose counterparty risk?

As noted in Section II. D. of our letter, FHFA should retain the authority to alter CRT structures.

Question 76. Should FHFA require an Enterprise to determine the credit risk capital requirement for retained CRT exposures using a modified version of the SSFA?

We find little difference in the treatment of CRT under a modified SSFA than under the proposed rule. Therefore, for the reasons given in Section II. D. of our letter, and related Appendices, we do not support the modified SSFA alternative and would encourage the use of an approach tailored to the specific business models of the Enterprises.

Question 77. Is the SSFA properly formulated for retained CRT exposures or should other risk drivers, such as maturity, be incorporated?

See our response to Question 76.

Question 78. Is the SSFA (particularly the supervisory adjustment factor, p) appropriately calibrated for retained CRT exposures?

See our response to Question 76.

Question 79. Should FHFA adjust the regulatory capital treatment for exposures to MBS guaranteed by the other Enterprise to mitigate any risk of disruption to the UMBS?

See Section II. H. of our letter.

Question 80. Should FHFA consider a different risk weight for second-level re- securitizations backed by UMBS?

See our response to Question 79.

Question 81. What should be the regulatory capital treatment of any credit risk mitigation effect of any indemnification or similar arrangements between the Enterprises relating to UMBS re-securitizations?

See our response to Question 79.

Question 82. Should FHFA adopt different risk weights for MBS guaranteed by an Enterprise and the unsecured debt of an Enterprise?

See our response to Question 79.

Question 83. Should FHFA require an Enterprise to separately determine its credit risk-weighted assets using its own internal models?

We support calculation based upon risk-grids and internal models. Use of internal models requires the Enterprises to improve their risk management systems.

Question 84. Should there be a prudential floor on the credit risk capital requirement for a mortgage exposure determined by an Enterprise using its internal models?

We believe that the minimum floor for the risk-weight calculation is sufficient.

Question 85. Should FHFA prescribe more specific requirements and restrictions governing the internal models and other procedures used by an Enterprise to determine its advanced credit risk-weighted assets?

No response.

Question 86. Should FHFA require an Enterprise to determine its advanced credit risk-weighted assets under subpart E of the Federal Reserve Board's Regulation Q? If so, what changes to that subpart E would be appropriate?

No response.

Question 87. Alternatively, should compliance with subpart E of the Federal Reserve Board's Regulation Q offer a safe harbor for compliance with the proposed rule's advanced approaches requirements?

No response.

Question 88. Should FHFA preserve the U.S. banking framework's scalar factor of 1.06 for determining advanced credit risk-weighted assets calculated?

No response.

Question 89. What transition period, if any, is appropriate for an Enterprise to comply with the proposed rule's requirements governing the determination of the Enterprise's advanced credit risk-weighted assets?

No response.

Question 90. What transition period would be appropriate if an Enterprise were required to determine its advanced credit risk-weighted assets under subpart E of the Federal Reserve Board's Regulation Q?

No response.

Question 91. Should there be an additional capital requirement to mitigate any model risk associated with the internal models used by an Enterprise to determine its advanced credit risk-weighted assets?

No response.

Question 92. Are the point and spread measures used to determine spread risk capital requirements for certain covered positions appropriately calibrated for that purpose?

We have no objection to this approach to market risk.

Question 93. Should there be a minimum floor on the spread risk capital requirement for any covered position subject to the internal models approach?

No response.

Question 94. Should FHFA adopt an approach to market risk capital that is more similar to the Basel framework, for example by limiting the scope of the market risk capital requirements to a smaller set of positions (e.g., those positions analogous to the trading book) or by requiring market risk capital for market risks other than spread risk (e.g., value-at-risk, stress value-at-risk, incremental risk, etc.)? If so, what positions and activities of the Enterprises should be subject to that approach?

See our response to Question 92.

Question 95. Should the spread risk and other market risks for single-family and multifamily whole loans instead be set in an Enterprise-specific manner through the supervisory process, taking into account the market risk management strategies employed by the Enterprise?

See our response to Question 92.

Question 96. Should FHFA assume interest rate risk is fully hedged for purposes of determining market risk capital requirements?

Given the complexity and convexity of retained Enterprise assets, FHFA cannot assume that interest rate is fully hedged.

Question 97. What requirements and restrictions should apply to the internal models used to determine standardized market risk-weighted assets?

See our response to Question 92.

Question 98. Are the requirements governing an Enterprise's internal models for determining spread risk capital requirements appropriately formulated?

See our response to Question 92.

Question 99. Should FHFA adopt a more prescriptive approach to the determination of advanced market risk-weighted assets, perhaps requiring an Enterprise to determine a measure of market risk that includes a VaR-based capital requirement, a stressed VaR-based capital requirement, specific risk add-ons, incremental risk capital requirements, and comprehensive risk capital requirements, as under the U.S. banking framework?

No response.

Question 100. Is the advanced measurement approach appropriately formulated and calibrated as a measure of operational risk capital for the Enterprises?

We have no objection to this approach.

Question 101. Should FHFA consider other approaches to calculating operational risk capital requirements (e.g., the Basel standardized approach)?

See our response to Question 100.

Question 102. Is the minimum floor on an Enterprise's operational risk capital appropriately calibrated?

See our response to Question 100.

Question 103. Are the differences between the credit risk capital requirements for mortgage exposures under the proposed rule and the U.S. banking framework appropriate?

As stated in Section I. B. of our letter, the Enterprises present a hybrid of banking and insurance activities. We appreciate and support FHFA's efforts to tailor the proposed rule to the banking framework, but we recognize both types of activities are present within the Enterprises. As we explain in our letter, we believe that the rule should be modified in several respects to achieve a better balance between the two types of business activities and their associated risks and risk management practices.

Question 104. Which, if any, aspects of the proposed rule should be further aligned with the U.S. banking framework?

See Section II of our letter. We propose modifications to better align the capital rule with the realities of the Enterprise business model.

Question 105. Are the delayed compliance dates tailored in a manner to promote the ability of an Enterprise to achieve compliant regulatory capital levels?

See our response to Question 7.

Question 106. Should FHFA conform the definition of “total exposure” in §1206.2 to have the same meaning as “adjusted total assets” as defined in §1240.2?

No response.

Question 107. In addition to the questions asked above, FHFA requests comments on any aspect of the proposed rule.

No response.