July 17, 2023

Financial Stability Oversight Council
Attn: Eric Froman, Office of General Counsel, Treasury
1500 Pennsylvania Ave NW
Room 2308
Washington, DC 20220

Re: Analytic Framework for Financial Stability Risk Identification, Assessment, and Response (FSOC 2023-0001) , and Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (FSOC 2023-0002)

Dear Mr. Froman:

The Housing Policy Council[1] ("HPC") is pleased to submit the following comments on the Financial Stability Oversight Council's (FSOC or the Council) proposed interpretive guidance[2] and analytic framework[3] (together the "Proposals"). HPC members have a direct interest in the Proposals as they relate to the potential designation of entities involved in the origination, issuance, and servicing of loans in mortgage-backed securities ("MBS") for the Private Label Securities ("PLS") market, the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac" and, together with Fannie Mae, the "Enterprises") and the Government National Mortgage Association ("Ginnie Mae").

HPC is concerned that the Proposals remove meaningful factors for consideration from FSOC's approach to the designation of nonbank financial companies for Federal Reserve Board oversight and prudential standards. Of note, if finalized, the new framework would permit FSOC to designate individual firms based on factors such as size and interconnectedness, rather than first considering broad-based risks and vulnerabilities that exist across firms, as is required under the current activities-based approach.

Our views on the Proposal are set forth in detail below. In Section I, we discuss our opposition to the proposed elimination of the preference for an "activities-based approach" to address systemic risks. In Section II, we contend that FSOC's rejection of cost-benefit analysis is contrary to legal precedent. In Section III, we recommend FSOC retain the requirement to assess the likelihood of material financial distress before designating a company for supervision by the Federal Reserve Board. And, in Section IV, we present our concerns with elimination of a formal Council vote to initiate Stage 1 research that precedes the designation consideration process.

[1] The Housing Policy Council is a trade association comprised of the leading national mortgage lenders and servicers; mortgage, hazard, and title insurers; and technology and data companies. 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 promotion of lending practices that create sustainable homeownership opportunities in support of vibrant communities and long-term wealth building for families. For more information, visit www.housingpolicycouncil.org

[2] *Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, 88 Fed. Reg. 26,234 (Apr. 28, 2023).

[3] *Analytic Framework for Financial Stability Risk Identification, Assessment, and Response*, 88 Fed. Reg. 26,305 (Apr. 28, 2023).

I. The "Activities-Based Approach"

The guidance currently in effect was promulgated in 2019 and incorporates lessons learned from the Council's first set of designations. In particular, the current guidance requires the FSOC look first to the primary federal and/or state regulators to address identified risks to financial stability, before the FSOC pursues designation of a nonbank financial company. Under the Proposals, the FSOC would still engage with federal and state agencies but could proceed with a designation process without preferential reliance on the expertise and authority of the primary regulators.

With this change, FSOC will revert to the former, pre-2019 approach, which prioritized designations and permitted FSOC to ignore or dismiss the professional judgments and/or remedial strategies of state and federal regulators as well as the effectiveness of their oversight and capacity to manage entities under their supervision. A return to that policy could lead to a repeat of the past, where certain decisions were not grounded in a well-informed understanding of market-wide vulnerabilities and market participants and, therefore, contradicted the input of primary regulators. The requirement to consult with and assent to expertise of the relevant state or federal agencies prior to any designation allows for consideration of the impact of current regulations on the identified risk and whether the regulations are sufficient, lacking, or even exacerbate the risk.

The housing finance market illustrates the merits of the activities-based approach over company designations. Recent FSOC reports have noted that, based upon their business models, nonbank mortgage companies may face liquidity challenges.[4] These potential challenges, however, are not unique to specific nonbank mortgage companies but are inherent to the business. An activities-based approach permits FSOC to evaluate such challenges across an industry rather than picking one or a few large market players and subjecting them to separate rules established by the Federal Reserve Board.

To some degree, the advantages of an activities-based approach have already been realized in the mortgage sector. Since FSOC began raising concerns regarding nonbank mortgage lenders, various regulatory bodies and federal program agencies, including the Federal Housing Finance Agency ("FHFA"), Ginnie Mae, the federal and state banking regulatory agencies, and the Consumer Financial Protection Bureau ("CFPB"), have taken steps to strengthen the capital rules, liquidity requirements, operational restrictions, mortgage servicing responsibilities, and consumer protection rules that apply to such companies. These actions mitigate FSOC's concerns while making housing finance one of the most regulated industries in the economy.

Another advantage of an activities-based approach is that it can address risks created or exacerbated by governmental policies. For example, in the mortgage sector, program rules at the Federal Housing Administration, the Veterans Administration, and Ginnie Mae that effectively limit private financing options, contribute to and compound the housing finance system's liquidity risks. A specific example helps to illustrate this point and show why an activities-based analysis is so important. Ginnie Mae servicers are required to make payment advances on behalf of delinquent borrowers for as long as it takes for the borrower to return to pay status (organically or through a loan modification) or the loan to be paid off or foreclosed. As a result, servicers may advance such payments for many months, both for taxes and insurance and for principal and interest. However, in addition to the challenges of the uncertain and protracted duration of a servicers' advancing responsibilities given FHA and VA servicing rules, Ginnie Mae's rules make it very difficult for private creditors to provide financing for advances on loans separately from financing for mortgage servicing rights (MSRs). This is a long-

[4] FSOC Annual Report 2022, p. 62-63.

standing industry concern, and one for which multiple solutions have been offered and rejected. Yet, this situation creates extended liquidity risk in the Ginnie Mae segment of the market that does not exist in the conforming, conventional segment, which caps advancing requirements and allows servicers to finance such advances.

FSOC highlighted this issue in its 2022 Annual Report,[5] but treated it as a liquidity concern with non-bank servicers, not as a consequence of Ginnie Mae policy. An activities-based approach could address this issue, to reduce or remove significant risk from the system.

Finally, prioritizing an activities-based approach does not preclude flexibility to designate a single entity. It simply structures the order in which various approaches will be considered to remain faithful to the principle that FSOC is not itself a primary financial regulator *and* to consider whether the risk is associated with the overall activity (like servicing loans in Ginnie Mae MBS) rather than a specific entity.

II. **Elimination of Cost-Benefit Analysis**

Under the current guidance, the Council considers the benefits and costs of a designation for the U.S. financial system and the relevant company and will designate a nonbank financial company only if the expected benefits justify the expected costs of the designation.

The Proposals would eliminate the cost-benefit analysis. This is contrary to legal precedent and the absence of such analysis could render designations to be arbitrary. Under the Administrative Procedure Act, agencies have a duty to engage in reasoned decision-making. A fundamental requirement of reasonableness is assessing the benefits relative to the costs of a proposed course of action. "One would not say that it is even rational, never mind 'appropriate,' to impose large costs in return for a few … benefits."[6] This is reaffirmed by the factors included in Section 113 of the Dodd-Frank Act, which state that FSOC designations are subject to judicial review under an arbitrary and capricious standard.[7]

Under Supreme Court precedent, the term "appropriate" is "the classic broad and all-encompassing term that naturally and traditionally includes consideration of all the relevant factors," including "at least some attention to cost."[8] Applying that precedent, the U.S. District Court for the District of Columbia ruling in *MetLife, Inc. v. Financial Stability Oversight Council* held that "FSOC [must] consider the cost of designating a company for enhanced supervision."[9]

The decision in the *MetLife* case reinforced the need for this type of analysis (which informed the 2019 guidance), "Because FSOC refused to consider cost as part of its calculus, it is impossible to know whether its designation does significantly more harm than good. That renders the Final Determination arbitrary and capricious."[10] The rationale provided in the Proposals for the elimination of a cost-benefit analysis requirement is therefore inconsistent with the legal precedent established by the ruling.

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[5] Id.
[6] *Michigan v. EPA*, 576 U.S. 743, 752 (2015) (hereinafter "*Michigan*").
[7] 12 U.S.C. § 5323(h).
[8] *Michigan*, 576 U.S. at 752.
[9] *MetLife, Inc. v. FSOC*, 177 F. Supp. 3d at 241 (2016)
[10] 177 F. Supp. 3d at 242.

The Proposals reference the decision in the *MetLife* case in a footnote:[11] "In the agreement MetLife expressly waived any right to argue that the cost-benefit portion of the district court's opinion had any preclusive effect in any future proceeding before the Council or in any subsequent litigation." Yet, MetLife's company-specific settlement terms did not invalidate the Court's reasoning regarding the need for a cost-benefit analysis in connection with designations.

FSOC's concerns about the great harms of financial crises and the difficulty of measuring them do not show that cost-benefit analysis is impossible. The Treasury Department itself, in a report preceding the 2019 Guidance,[12] offered two compelling reasons why FSOC should conduct such analysis, despite the practical challenges associated with the quantitative research required. First, the analytical discipline of weighing costs against benefits—and quantifying those impacts to the extent feasible—improves the quality of administrative decision-making, obligating agencies to take account of the relevant trade-offs and alternatives. Second, agency action is appropriate only if it does more good than harm, and there can be no confidence on that point unless the Council weighs the costs and benefits of its actions.

III. Elimination of the Likelihood of Material Financial Distress Analysis

Under the Proposals, the Council would not assess the likelihood of a company's material financial distress in considering a nonbank financial company for designation under Section 113. The Proposals indicate that FSOC should not focus on whether an entity *does* pose a risk, but rather whether it *could* do so. Similar to the language regarding a cost-benefit analysis, the Council states that a determination of the company's material financial distress is not required or appropriate.

Section 113 of the Dodd-Frank Act permits FSOC to designate a company if "material financial distress" at the company "could pose a threat to the financial stability of the United States."[13] This text indicates that an actual, existing form of distress may pose a threat, not that a potential, theoretical threat should be considered. In other words, the conditional word "could" does not empower FSOC to conceive of possible future threats, but instead compels FSOC to evaluate the possible impact of real and present distress. As written, a plain reading of the provision necessarily requires FSOC to consider: (1) to what extent there is existing or imminent risk of material financial distress at the company and (2) the effect of any such distress on the broader financial system. Both considerations are necessary, because if a company faces de minimis likelihood of distress, there likely is no threat that distress at the company will harm financial stability.

This empirically-based approach, which is embedded in the 2019 guidance would prevent inappropriate designations, which are not likely to be supported by an entity's primary functional regulator(s), such as the Prudential determination. The FSOC analysis of the threat posed by Prudential did not fully account for the stability of Prudential's liabilities, the quality of its assets, or the strength of its equity capital. The Prudential analysis also did not consider the characteristics of the company's derivatives activities. While in aggregate, Prudential had a large derivatives portfolio, the largest component were interest rate swaps – which are wholly appropriate and consistent with strong risk management for the type of business Prudential operates.

Eliminating the assessment of actual risk posed (rather than the theoretical possibility of risk) will permit the Council to ignore or dismiss supplementary or complementary actions taken by a

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[11] Propose Guidance, 88 Fed. Reg. at 26,238.

[12] U.S. Treasury Report to the President of the United States *Financial Stability Oversight Designations*, November 17, 2017, at 27.

[13] 12 U.S.C. § 5323(a)(1).

company or a company's counterparties or regulators, including practices or requirements that enhance the mitigation or management of risks. This may lead (again) to flawed analyses that report aggregate, rather than moderated, exposure to conclude erroneously that large notional exposures pose a threat to the US financial system.

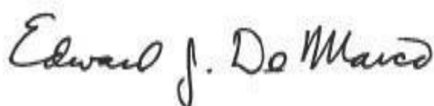
IV. Elimination of FSOC Vote to Initiate a Company Review

We support the existing FSOC practice to safeguard information about companies identified for and/or under review for possible designation. However, we are concerned that the proposed designation process will remove the 2019 requirement for a formal FSOC vote to initiate the Stage 1[14] research for any company or group of companies. The proposed process will require a vote only to move from Stage 1 to Stage 2.[15] A staff-led initiation of a company review, in lieu of a formal Council vote, undermines the discipline provided by affirmation from all members, including primary regulators with oversight authority, and, as a result, undermines procedural protections for companies facing potential designation. Given the *nondelegable* duty of FSOC voting members to decide whether to designate a company, the initial phase of the process, in which members agree to perform required research, must also be subjected to full member consideration and agreement. The statutory purpose of FSOC was to create a forum for regulatory coordination. With this change, the proposal diverges from that statutory intent, to empower the staff of FSOC members to singlehandedly initiate the process, which diminishes FSOC's effectiveness as a coordinating body.

V. Conclusion

HPC appreciates the opportunity to comment on FSOC's Proposals. Financial stability is a matter of utmost concern to HPC and its members, and we consistently support efforts to identify and address systemic financial risk. As such, we recommend FSOC retain the "activities-based approach," the cost-benefit analysis as well as the requirement to perform analysis to assess the likelihood of material financial distress before a designation. Should you have any immediate questions regarding these comments, please do not hesitate to contact us.

Yours truly,



Edward J. DeMarco
President
Housing Policy Council

[14] See 12 CFR Part 1310, Appendix discussion of stage 1 identification, "The Council will vote to commence review of a nonbank financial company in Stage 1."
[15] See 88 Fed Reg. 26241 (April 28, 2023)