Whalen Global Advisors LLC

February 28, 2022

Sandra Thompson
Acting Director
Federal Housing Finance Agency
Constitution Center
400 7th Street, SW
Washington, D.C. 20219

Dear Director Thompson,

This letter is in response to your agency's request for "Input on Strategic Plan for Fiscal Years 2022-2026."

Under Strategic Goal 1, you say that the FHFA must ensure that "each regulated entity operates in a safe and sound manner, including maintenance of adequate capital and internal controls." The goals that follow, however, such as providing support for low- and moderate-income families, detract from safety and soundness due to the higher propensity to default in such populations and related loss mitigation expenses.

Q: Has FHFA and/or the GSEs prepared a cost-benefit analysis of these divergent goals? How do you decide when supporting housing goals is compromising safety and soundness for the GSEs? FHFA should publish its methodology for managing this clear conflict in public policy.

Likewise in Section II, you note that the FHFA has a statutory responsibility to "implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer, to take advantage of…available programs to minimize foreclosures."

Q: Again, how does FHFA and/or the GSEs assess the clear economic tradeoff between safety and soundness and its duty to help homeowners at the expense of note holders, loan servicers and guarantors?

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In terms of safety and soundness, the FHFA and the GSEs are following a regulatory framework for the Enterprises that largely mimics the approach of prudential regulators when supervising insured depository institutions. Given that the GSEs are merely finance companies with federal credit guarantees, FHFA needs to state why applying rules for federally insured banks will make the GSEs safe and sound long term.

Q: Why does FHFA think that following a bank-centric approach to regulating the "safety and soundness" of the GSEs is appropriate? In the event that the GSEs exit conservatorship, does the FHFA actually believe that the proposal framework will ensure that these entities are safe and sound operating <u>without a federal guarantee for the issuers</u>?

So long as the GSEs are in conservatorship, capital is unnecessary because of the "AAA" credit support from the United States, both for the entities themselves and their secured and unsecured debt obligations. Once the GSEs leave government control, however, liquidity rather than capital will become paramount. Liquidity is a function of credit ratings, which in the case of the GSEs post conservatorship is likely to be below "AAA" from the major credit rating agencies. As a result, we would argue that the focus of FHFA regulation for safety and soundness ought to be ensuring adequate liquidity rather than static capital.

Likewise under Objective 1.1, the request states that the GSEs must "Ensure the Enterprises establish and maintain standards for sellers, servicers, and counterparties that strengthen the overall functioning and resiliency of the mortgage markets." In fact, most of the proposals from the FHFA and Ginnie Mae (GNMA) with regard to issuers have focused on raising static net worth requirements and reducing operating leverage, changes that by definition will reduce liquidity and loan volumes in the secondary market for conventional loans. More "capital" means less leverage, lower loan volumes and reduced profits.[1]

In Objective 2.1, FHFA talks about meeting various affordable housing mandates, then in passing mentions that the Federal Home Loan Banks (FHLBs) ought to be managed in a safe and sound manner. In fact, if we accept the premise that liquidity and not capital is the key risk criteria for both the GSEs and private nonbank issuers, then the FHFA needs to reexamine how it regulates the FHLBs and particularly the prohibition on nonbanks accessing the system via regulated entities such as insurance companies.

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[1] We will be addressing the new issuer eligibility rules proposed by the FHFA in a separate letter.

If the FHFA is truly serious about reducing risk to the conventional market, then it should immediately reverse the decision by the FHLBs to reject membership by adequately capitalized insurers owned by nonbank issuers. Having any company access the FHLB through a regulated entity such as an insurer, using acceptable collateral, should more than satisfy the counterparty risk requirements of the FHFA and the GSEs. Indeed, given the loud protestations about the lack of regulation of nonbank issuers, FHFA ought to publicly explain why having regulated insurers owned by nonbanks facing the FHLBs is risky.

How is it that the FHLBs can justify providing financing for risky assets such as CLOs issued by thinly capitalized funds and REITs, but conventional mortgage issuers with eligible collateral that actually support the mission set by Congress are unacceptable?[2] Are the FHFA and the Enterprises suggesting, through this unwritten prohibition, that the regulation of insurance companies under state agencies and the National Association of Insurance Commissioners (NAIC) is somehow inadequate? The position of the FHFA and the FHLBs with respect to nonbank issuers that own NAIC members is a national scandal that demands immediate action.

Near the end of the request, the FHFA includes the following passage:

> "FHFA does not currently possess the power to examine important counterparties of its regulated entities, such as nonbank servicers. This could interfere with FHFA's ability to ensure the safety and soundness of the regulated entities and the resilience of the nation's mortgage markets."

Sadly this statement is inaccurate. Giving the FHFA the power to examine nonbank mortgages companies does not support the mission of the FHFA or the Enterprises. The key risk to the Enterprises is liquidity risk, whether from changes in the macro economy or elevated levels of delinquency. Given the legal position of the GSEs with respect to conventional loans and the associated servicing assets, whether an individual issuer fails financially should not matter to the FHFA and the GSEs, which have absolute control over conventional loans and related servicing assets.[3]

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[2] "ELIGIBILITY CRITERIA FOR SECURITIES PLEDGED AS COLLATERAL, Federal Home Loan Bank of Des Moines.

[3] Whalen, Richard Christopher, Improving Liquidity for Ginnie Mae Servicing Assets (February 2, 2022). Available at https://ssrn.com/abstract=4024289

In the more recent request regarding issuer eligibility, FHFA nicely states the true case:

> "The eligibility requirements are not regulatory requirements, and a seller/servicer that does not wish to do business with the Enterprises is not required to meet them. The Enterprises do not regulate seller/servicers but, as a matter of prudent risk management, they consider possible risk exposure from contractual relationships with seller/servicers and assess, monitor, and take appropriate actions to address the risks to which they are exposed in their business relationships."

This is the appropriate way for the Enterprises to view their relationship with all issuers, banks or nonbanks. Taylor Bean & Whitaker, after all, was a bank. So were Countrywide, Wachovia, and Washington Mutual. Lehman Brothers owned a thrift. Just having big commercial banks as issuers is not a panacea for mitigating liquidity risk to the Enterprises. Indeed, the superior operating efficiency of nonbanks makes them better able to adjust to changes in the macro economy and interest rates, the key risk to all participants in the secondary mortgage market.

As suggested in the passage above, the FHFA should avoid the temptation to play prudential regulator and instead assume the demeanor of banker and servicer provider. By focusing on the credit standing of the issuers and therefore liquidity, we can all support the core mission from Congress, namely encouraging and fostering *private* mortgage finance for all Americans. The strength of the broader housing market lies in the federally guaranteed assets of housing finance, and not in the individual private issuers.

Without a federal guarantee for the corporate entities, the GSEs are just big finance companies with inflated expenses and fees that would be severely cut back as private issuers. In the event either of the GSEs ever leaves conservatorship, they would likely face tough competition with the likes of JP Morgan (JPM) or PennyMac (PFSI).

An astute investor will buy a conventional MBS with a Treasury credit wrap just as readily from a "private" GSE with a A+ rating as from JPM. JPM's lead bank is a "AA" credit, after all, because big banks are GSEs too. Indeed, once Fannie Mae and Freddie Mac leave conservatorship, they would no longer be viewed as GSEs in the credit markets. As and when Fannie Mae and Freddie Mac ever leave government control, then they too will be subordinate to the largest banks.

Whether or not an issuer fails or not should be a matter of complete indifference to the lender banks and the GSEs. So long as the market for conventional loans is healthy and attractive to private capital, the federally guaranteed collateral is all that matters. If investors want to own conventional assets, then FHFA and the Enterprises will be able to support the mission set by Congress.

The insolvencies of ResCap and Ditech, and the bank failures listed above, all illustrate that issuer failures are resolved in the normal course with no disruption to consumers.[4] So long as a conventional servicing book is financially attractive to investors, the markets will solve the problem of liquidity and insolvency. Imposing arbitrary financial standards, on the other hand, will not address risk and instead will provide a false sense of security on the part of regulators and liquidity providers. Lawrence Platt writes:

> "[A] mortgage servicer's default, under either a servicing agreement or a commercial loan agreement, theoretically could result in a mortgage servicer failure with resulting harm to borrowers. The fact that this 'parade of horribles' could occur does not mean that it is reasonably likely to occur—that either a servicer would fail or, if it did, the failure would cause widespread harm to borrowers. Indeed, Fannie Mae, Freddie Mac, and Ginnie Mae have subservicers in place to take over the servicing functions on an interim basis for servicers terminated with cause. They have utilized these arrangements for years without reports of material consumer harm." [5]

While the FHFA can and should set financial standards for issuers, it should not conduct inspections of private companies. Without the prudential powers of Section 12 applicable to banks, inspecting nonbanks would be an absurd waste of time and resources for the FHFA. Instead, FHFA should cooperate with state and federal regulators, who do have prudential powers to license and examine mortgage firms. Make the Conference of State Bank Regulators earn that seat at the big table in Washington. FHFA should focus on helping to enhance the liquidity and profitability of all conventional issuers in a safe and sound manner, but leave the regulation of nonbanks to state regulators.

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[4] Whalen, Richard Christopher, Assessing Involuntary Termination Risk on Residential Mortgage Servicing Rights (March 17, 2017). Available at SSRN: https://ssrn.com/abstract=2936422

[5] Platt, Lawrence, "State Prudential Standards for Mortgage Servicers: "Ahead of the Curve" or "Dead Man's Curve"?, *Lexology*, December 2020.

Enabling nonbanks to access the FHLBs ought to be a key part of the FHFA's agenda to enhance issuer liquidity. Another priority for the future is to restore access to the Enterprises for smaller bank and nonbank issuers to create liquidity for seasoned loans. There is a significant liquidity problem festering among smaller banks and credit unions because the decision by FHFA to close the door on the GSEs guaranteeing structured transactions with prime, seasoned loans held in portfolio by community lenders. The movement in the Treasury yield curve in 2022, not a lack of capital, has caused this liquidity problem.

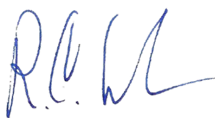
Only by having a healthy market for housing finance can the Enterprises meet their legal mission to serve the needs of all Americans. And only by supporting the smaller issuers, including community banks, credit unions and independent mortgage banks, can the FHFA fulfill its responsibility to help the underserved. Large banks cannot meet the goals set by Congress for helping underserved communities.

In 2022 and beyond, the FHFA ought to stop pretending to be a prudential regulator and instead refocus its talented people and resources on serving the needs of the entire conventional market, issuers and borrowers alike. Instead of the present adversarial posture, FHFA instead should adopt a culture of service to all members of the conventional community. Be part of the solution instead of the source of the problem.

To reduce risk in the conventional market, FHFA should pursue policies that will enhance liquidity, particularly liquidity for smaller issuers as delinquency levels inevitably increase from historic low levels. Small banks and IMBs have the operational ability and economic incentive to meet the convenience and needs of those populations that most need public support.

We are happy to discuss these comments with FHFA staff. A related article is attached for your information.

Yours sincerely,



Christopher Whalen
Chairman

National Mortgage News
Will FHFA create a level playing field for nonbanks?
By Christopher Whalen
February 07, 2020

Federal Housing Finance Agency Director Mark Calabria promised to change his agency. So far he is not disappointing.

In addition to pushing to move Fannie Mae and Freddie Mac out of federal conservatorship, he is also making some changes to how all four government-sponsored enterprises — the others being Ginnie Mae and the Federal Home Loan Banks — operate and are regulated. The mixture so far is a combination of positives and negatives, but the long-suffering independent mortgage banks — also known as nonbanks — may yet get some respect.

Last year, Calabria was responsible for raising the question of nonbank risk with the Financial Stability Oversight Council. This writer released a paper rebutting the 2019 FSOC report, which claims rather incredibly that nonbank mortgage servicing companies could pose a “systemic risk” to the markets and the U.S. economy. The FSOC report singles out potential liquidity risks arising from nonbanks servicing defaulted mortgages and also risk to banks that finance these activities. Yet today, commercial banks still have 80% market share in mortgage servicing, as shown below.

More than anything else, the FSOC's accusations against nonbanks reflect a very poor understanding of the world of secured finance. The first big question for Calabria and his colleagues at the FHFA is whether or not they understand that the attitude of the FSOC and bank regulators behind it is antithetical to the mortgage industry. Prudential regulators hate small residential mortgages of the type seen in the government market and Ginnie Mae securities, and especially dislike nonbanks.

Prudential regulators hate nonbanks, first and foremost, because they're not banks. Nonbanks are far more efficient than commercial banks. Nonbanks actually make most of the mortgage loans in the U.S. each year. Fed researchers refer pejoratively to nonbank finance companies as "shadow banks."

But to paint nonbanks as a source of systemic risk, particularly given the track record of commercial banks in causing the 2008 subprime mortgage fiasco, seems absurd. But let's go down memory lane for just a moment.

In the early 1980s, just before the nonbanks known as savings and loans were tossed into the wood chipper, Citibank introduced a new global product called "Mortgage Power." This no-doc, no-income verification product was designed for the self-employed.

The first truly subprime mortgage loan product offered by a large U.S. bank, Mortgage Power was an unmitigated disaster. By the early 1990s, Citi's credit losses in mortgages were in double digits and Mortgage Power was shuttered.

By 2000, however, Citi was ready to dive back into the subprime mosh pit. It acquired Associates First Capital, the largest consumer finance company, in September 2000. This acquisition set the stage for the bank's collapse in 2008. Citi, in particular, was responsible for socializing the no-doc, no-income verification subprime toxic loan that was the dominion of finance companies for the world of federally insured banks. Countrywide, WaMu, Lehman Brothers and Bear Stearns merely followed Citi's pioneering lead.

Today, as in 2008, nonbanks are the customers of banks. The risk, the collateral and the capital of the nonbanks is held by a bank that finances the mortgage business. The world of mortgage finance is fully collateralized in terms of credit, self-liquidating in terms of legal resolution and fully hedged in the to-be-announced markets in terms of liquidity (i.e., collateral) risk. Commercial bank lenders oversee and supervise this risk taking and post 100% capital against mortgage lines as per Basel III.

Simply stated, the world of mortgage finance is the least risky part of the U.S. fixed-income markets. Yet the FHFA just issued a new proposal for capital rules for GSE seller/servicers that reflect the anti-nonbank mentality that seems to pervade much of the world of Washington. FHFA's rule would set higher capital requirements for seller/servicers operating in the government-insured market of the Federal Housing Administration/U.S. Department of Agriculture/Veterans Affairs loans and Ginnie Mae securities, companies that are predominantly nonbanks.

The fact is that, with notable exceptions such as Flagstar and Cenlar, nonbanks are the only lenders and servicers that are able to operate in the government loan market profitably. But the FHFA seems intent upon penalizing the nonbank issuers operating in the government market, without any recognition of the superior operating records and financial performance nonbanks have achieved. Dollar-for-dollar of capital employed, nonbanks generate more revenue and create far less net risk in the markets that do commercial banks.

The growth in the Ginnie Mae market since 2008, from low single digits to more that 20% of total issuance, was created by nonbanks. If Calabria really wants to address risk in the mortgage market, why doesn't FHFA try to be helpful to nonbanks for a change? Specifically, the FHFA should help increase nonbank liquidity by allowing nonbanks to be full members of the Federal Home Loan Banks.

The Wall Street Journal reports that the FHFA may soon allow nonbanks to become members of the FHLBs, an important change that would diversify sources of liquidity for nonbanks and provide a countercyclical buffer for the housing sector. Few people remember that in the dark days immediately following 2008, the FHLBs provided enormous liquidity to the banking system that helped to avoid dozens more failures of community banks.

Just as small banks have few sources of liquidity — and fewer friends in Washington than do the biggest banks — nonbanks have only a couple of choices when it comes to financing loan production and fixing defaulted loans, cash on hand or a bank credit line. Some of the more sophisticated nonbank lenders also access the short-term repo markets to finance dry

government and agency mortgage notes. But providing nonbanks access to the FHLBs would provide an important liquidity backstop for all independent mortgage bankers.

For years, recalcitrant elements within the FHLBs have resisted the idea of allowing "unregulated" nonbanks back into the system either directly or via captive insurance companies. After all, the first members of the FHLB System were insurance companies. But captive insurance subsidiaries of mortgage banks and REITs have been wrongly criticized by bankers, who treat the FHLBs as their private funding vehicle. But why should JPMorgan and Wells Fargo get subsidized access to the FHLBs, but not independent mortgage bankers and REITs?

While he is imposing new capital requirements on nonbanks, Calabria might consider being helpful as well. Open FHLB membership to any entity that supports mortgage finance, either as a lender or investor, and has eligible collateral to access credit from the system.

Any nonbank that can meet the FHLB rules and has collateral should be allowed to access the credit available to JPMorgan and Wells Fargo. And when the bank lobbyists and regulators start to whine about the risk from nonbanks, Mark, just remember two words: Mortgage Power.

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