Heritage One Properties

May 7, 2023

Honorable Sandra Thompson
Director
Federal Housing Finance Agency
400 Seventh Street, SW
Washington, D.C. 20219

Director Thompson,

I am writing to express my deep concerns regarding the appropriateness of continuing to link upfront and total guarantee fees to the 2020 Enterprise Regulatory Capital Framework (ERCF) for Fannie Mae and Freddie Mac. It is my firm belief that the ERCF must be adjusted to require a lower and more reasonable risk-based capital requirement that does not compromise the goal of safety and soundness, while also supporting ongoing efforts to ensure affordable housing for Americans nationwide.

Fannie Mae and Freddie Mac were chartered with the noble objective of making the housing market more accessible to borrowers across the country by providing liquidity in the secondary housing market. By facilitating liquidity in the secondary housing market, these GSEs aimed to ensure a consistent flow of mortgage funds, enabling lenders to extend credit to a wider range of borrowers. The goal was to democratize homeownership, making it attainable for a greater portion of the American population. This mission is enshrined in the very fabric of their existence, and any regulatory framework governing their operations must align with this core objective. However, the 2020 ERCF undermines this core mission by imposing unnecessarily high capital requirements on Fannie Mae and Freddie Mac.

The 2020 ERCF, as currently formulated, imposes disproportionately high capital requirements on Fannie Mae and Freddie Mac. While the intention behind bolstering safety and soundness is commendable, the existing framework fails to strike an appropriate balance. The excessive capital demands impede the GSEs ability to fulfill their core mission effectively. By diverting significant financial resources to maintain heightened capital levels, Fannie Mae and Freddie Mac face limitations in deploying capital towards initiatives aimed at fostering affordable housing. This compromises the original charter and hampers their ability to create sustainable homeownership opportunities for aspiring Americans.

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One of the primary concerns with the ERCF is that its metrics for determining capital requirements are not adequately tied to established models of risk. The regulatory framework fails to accurately assess the actual risks faced by Fannie Mae and Freddie Mac, thereby resulting in inflated capital requirements that are not commensurate with the true level of risk inherent in their operations. This disconnect between risk assessment and capital requirements is a critical flaw that undermines the effectiveness and fairness of the ERCF. Cross-subsidization is most successful when there exists a close correlation between mortgage credit risk and required capital.

A fundamental flaw of the ERCF lies in its failure to tie capital requirements to established risk models. The absence of a direct correlation between risk and capital can lead to an unjustifiably cautious approach. It is crucial to recognize that the housing market exhibits unique risk characteristics that require specialized models to evaluate risk. By disregarding these models, the current ERCF undermines the efficacy of capital requirements. A more nuanced approach, accounting for market-specific risk factors, would allow for a better alignment between capital demands and actual risk, enabling a more efficient allocation of resources.

The Controversy Caused over LLPAs

The recent controversy over LLPAs highlights the need to set appropriate capital levels that balance safety and soundness as well as promote affordable housing. If reasonable overall guaranty fees are set, with lower-risk loans receiving a moderate degree of overpricing, the GSEs could generate surplus fees that could strategically reduce fees on higher-risk loans by substantial amounts. However, the current framework requires several non-risked based cushions that result in excessively high guaranty fees on the lowest-risk loans. Consequently, any further increase in fees to cross-subsidize higher-risk loans is more likely to be perceived and criticized, as exemplified by the recent Loan-Level Price Adjustment (LLPA) changes introduced by the FHFA.

For example, the current application of a minimum capital requirement of 1.6 percent to all loans, raises the required ROEs on lower-risk loans to a level where the potential for effective cross-subsidization is practically eliminated. To impose this 1.6 percent capital minimum, irrespective of their credit risk, is highly unjustified. Without this minimum, the guaranty fees on the lowest-risk mortgages would generate returns well above the overall target return on equity (ROE), which in turn could be used to cross-subsidize higher-risk loans, further assisting low-income homebuyers through cross-subsidization.

Paradox of the Stability Buffer

I also firmly believe that the stability buffer imposed on Fannie Mae and Freddie Mac is an unjust and counterproductive measure. The stability buffer operates as a non-risk-based capital penalty, seemingly with the purpose of reducing the size of the GSEs. By increasing their capital requirements based on market share, this stability buffer almost forces Fannie and Freddie to reduce their share of the mortgage market.

The purpose of the stability buffer is not economic, rather it appears to be political. It appears to be formulated because of the erroneous notion that higher market shares held by Fannie and Freddie contribute to increased systemic risk. But as recent evidence demonstrates, through the failure of Silicon Valley Bank, Signature Bank, and First Republic Bank, this approach is fundamentally flawed in its assumptions. By shifting more of the secondary mortgage market away from the GSEs and onto commercial banks, the ERCF is tragically increasing systemic risk. It is critical to acknowledge that, according to data from the Federal Deposit Insurance Corporation (FDIC), banks have consistently exhibited high delinquency and default rates on residential mortgages, far exceeding the delinquency and default rates of Fannie and Freddie. It is the GSEs, who do not bear the risk of short-term consumer deposits and purchased funds, that are more adept at mitigating risks associated with residential mortgages compared to commercial banks. Because GSEs rely on funding from retirement funds and mutual funds, the funding sources behind their MBS are stable and well-equipped to manage interest rate risk.

Dodd-Frank Stress Test Results

The annual Dodd-Frank Act Stress Tests have consistently demonstrated the resilience of Fannie Mae and Freddie Mac in the face of severe economic stress conditions. These tests simulate a range of adverse scenarios, including high unemployment rates (10%) and significant home price declines (29%) akin to the 2008 Financial Crisis. Remarkably, the GSEs have not only maintained their capital levels but have also exhibited positive cash flow throughout these stress tests. This resilient performance attests to the robustness of Fannie Mae and Freddie Mac, undermining the argument for excessive capital requirements under the current ERCF.

The results of the annual stress tests unequivocally highlight the robustness and resilience of Fannie Mae and Freddie Mac. Even when subjected to highly challenging economic conditions, including the arbitrary requirement to write down deferred tax assets, the Enterprises would only experience a loss of $6 billion in capital. Such minimal capital loss in the face of extreme stress is a testament to the prudent risk management practices and financial strength exhibited by Fannie Mae and Freddie Mac.

The primary line of business for Fannie Mae and Freddie Mac is guaranteeing the credit of residential mortgages. For a credit guarantor, the role of capital is to act as a buffer against losses that surpass the revenues generated by performing loans during stressful periods. To determine the appropriate capital amount, it is necessary to conduct stress tests that simulate adverse scenarios. Remarkably, the FHFA does not include guaranty fee income as capital in the ERCF. This omission leads to a fundamentally flawed outcome and it raises questions about the rationale behind not counting guaranty fee income. The FHFA justifies its approach by labeling it "conservative." However, it is essential to recognize that conservatism in ERCF would involve adjusting the prepayment rate on surviving mortgages, particularly when compared to historical data. For instance, if Fannie Mae's 2007 book of business experienced an annual prepayment rate of 20.9 percent. A “conservative” approach would entail setting a higher annual percentage for the prepayment rate, perhaps 25 percent. However, not counting guaranty fees at all in the ERCF is indefensible and hinders a comprehensive assessment of their capital adequacy. Moreover, excluding this income, which nearly all commenters on that rule recognized as unjustifiable, undermines the credibility of the ERCF as a tool for simply guaranteeing safety and soundness, and it undermines the charter mission to provide stable and affordable housing in the US.

Given the evidence provided by the stress tests, the ERCF's current capital requirements for Fannie Mae and Freddie Mac far exceed what is necessary to ensure safety and soundness. The excessively high capital burdens imposed by the ERCF not only hamper the ability of the Enterprises to fulfill their mission effectively but also undermine ongoing efforts to make housing more affordable for Americans. These capital requirements divert financial resources away from supporting affordable housing initiatives, hindering the very goal that Fannie Mae and Freddie Mac were established to achieve.

It should not be overlooked that significant post-crisis enhancements in regulatory oversight and risk management practices at the Enterprises deserve due credit. The Housing and Economic Recovery Act of 2008 has empowered FHFA as a stronger and more independent regulatory agency, equipped with bank regulator-like powers and authorities. As a result of FHFA's regulatory and supervisory efforts, substantive and durable enhancements have been made to Fannie Mae's business practices, including liquidity and credit risk management policies and practices.

In light of the above arguments, I strongly urge you to consider adjusting the ERCF to require a lower and more reasonable risk-based capital requirement which would align better with the original mission of Fannie Mae and Freddie Mac. Instead of penalizing these entities for their success and effectiveness in managing risk, it is essential to recognize their invaluable contribution to the stability of the mortgage market. By recalibrating the ERCF, we can strike a better balance between ensuring safety and soundness and preserving the goal of accessible and affordable housing for the American population.

Thank you for your attention to this matter. I trust that you will give careful consideration to the concerns raised in this letter. The future stability of the mortgage market, as well as urgent need for affordable housing on a national level, depend on it.

Kind Regards,

Shane Koehler

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