November 15, 2018

Federal Housing Finance Agency
Office of Financial Analysis, Modeling & Simulations
400 7th Street SW, Ninth Floor
Washington, DC 20024
[via electronic submission]

Assessments: Enterprise Capital Requirements Comments/RIN 2590-AA95

Dear Sir or Madam:

The Structured Finance Industry Group ("SFIG")[1] appreciates the opportunity to comment on the Federal Housing Finance Agency's ("FHFA") Proposed Rule on Enterprise Capital Requirements (the "Proposed Rule"). SFIG's views are based on opinions from the members of its GSE Reform Task Force ("Task Force"). The Task Force is comprised of constituencies from all areas of the residential securities market, including investors, issuers, servicers, due diligence firms, law firms, trustees, accounting firms, rating agencies and other market participants.

Initial General Observations

SFIG's initial reaction regarding the release of the Proposed Rule is that the proposal is both welcome and timely.

The release is welcome to us on several levels. First, the very fact that the FHFA has spent such a great deal of time and hard work on the Proposed Rule certainly demonstrates that FHFA has given much thought to this very challenging undertaking. We believe that your time and effort to date has been well spent, and is necessary to inform future policy discussions

[1] SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, to drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. Members of SFIG represent all sectors of the securitization market, including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. Further information can be found at www.sfindustry.org.

regarding the end of the Conservatorships. Second, the Proposed Rule has implications, in our view, even beyond of the context of the Enterprises, in providing a framework for the evaluation of mortgage credit risk to a level of detail not previously attempted. Third, the Proposed Rule has additional implications, in our view, for the potential expansion of risk transfer beyond the Enterprises current Credit Risk Transfer ("CRT") programs.

We believe also that the release of the Proposed Rule for comment is especially timely. For perhaps the first time since the financial crisis of 2008-2009, overall economic conditions in the United States are experiencing a return to normalcy as suggested by key economic drivers such as labor force participation, employment, housing price appreciation and interest rates. Should this trend continue, we would expect a corresponding increase in the rate of household formation, one of the principal drivers of demand for homeownership. Another sign of normalcy is the recent increased activity in the non-agency "private label" mortgage space.

So, for all of these reasons, it appears to us that now is a particularly opportune time to re-address the issues that the FHFA has considered in the Proposed Rule. It is better to consider these issues now, before the improved economic climate reverses itself, as it will at some point, and the housing finance market again finds itself in a less stable condition.

SFIG's Main Positions in the Area of Housing Finance

As a prelude to our observations regarding the Proposed Rule, SFIG would like to reiterate several of our fundamental positions regarding the respective roles of the Enterprises and of private capital in the context of U.S. housing finance.

- *The PLS Market*. As we have said in all of our housing-related commentary since the financial crisis, SFIG continues strongly to believe that reinvigorating the non-agency private label mortgage-backed securities ("PLS") market should remain an important priority for both the FHFA and for the broader housing finance industry. This remains our single, most fundamental position. Consequently, in our specific observations and comments below, we will examine several aspects of the Proposed Rule in light of this position.

- *The CRT Program*. We believe that the CRT program has been, as we stated in our October 13, 2016 response to the FHFA's Request for Input on Single-Family Credit Risk Transfer (the "2016 CRT Letter"), "a great success" and, as we further stated in the 2016 CRT Letter, we see no reason why the CRT program should be viewed as a temporary "crisis era" program rather than as a permanent feature in the Enterprises' risk management strategies. As outgoing Fannie Mae Chief Executive Officer Timothy Mayopoulos noted in a recent Wall Street Journal interview, "The most important challenge [Mr. Mayopoulos faced] has been the most recent one, which is changing the business model of [Fannie Mae] to become a distributor of credit risk as opposed to a holder of credit risk". Since the capital markets are the deepest markets of all for the distribution of risk, it is hard to envision the challenge Mr. Mayopoulos identifies being met in the

absence of a robust CRT capital markets-based program such as STACR and CAS.

- *The Need for a Government Backstop in Times of Stress*: SFIG also acknowledges that the Enterprises, or their successors, will likely play a role in any future U.S. housing finance market as a counter-cyclical provider of mortgage credit. Although we re-emphasize SFIG's commitment to the first position noted above – the reinvigoration of the PLS market – we are also realists, and recognize that in periods of severe financial stress there is generally no substitute for a government backstop.

We provide below our observations on some aspects of the Proposed Rule in light of these three positions.

The Enterprises' Capital Requirements Should Not Unduly Encourage the Assumption of Mortgage Credit Risk by the Enterprises

While Mr. Mayopoulos identified his biggest challenge at Fannie as being the shift in business model from a holder of credit risk to a distributor of credit risk, we are inclined to broaden his insight across the overall mortgage finance industry. Specifically, SFIG believes that, although the distribution of mortgage credit risk by the Enterprises is an important goal, we cannot lose sight of the fact that not having the Enterprises assume mortgage credit risk in the first place is an even better result than assuming such risk and then distributing it.

What this means to us in terms of Enterprise capital requirements is that those requirements should be established so as not to encourage mortgage lenders to engage in "regulatory arbitrage" and sell loans to the Enterprises in such a way that mortgage credit risk accumulates on the Enterprises' books unnecessarily, or without there being an economically justifiable reason. This result is best achieved, we believe, by developing and maintaining a level playing field for capital to facilitate capital flows to multiple types of entities to bear mortgage credit risk and not to distort credit decisions. What this means in practice is that the Enterprises' capital requirements cannot be viewed in isolation.

The desirability of a level of playing field approach is highlighted when the Enterprises' capital requirements are contrasted with those applicable to other entities that are also subject to regulatory capital requirements, such as depository banks and mortgage insurance companies. Banks and mortgage insurance companies have significant interactions with the Enterprises, and different regulatory capital standards among them could lead to distortionary transactions.

By way of illustration, assume an individual mortgage loan with a specified borrower, on a specified property, and serviced by a specified servicer. Our common-sense observation is that this specified mortgage has a specified amount of risk attached to it at the individual asset level, and that amount of risk does not change whether the mortgage is held by a bank or by an Enterprise. There may be arguments that our initial observation is incorrect for reasons that are idiosyncratic to the Enterprises. For example, perhaps there is an argument that having that loan pass though the Enterprise's boarding procedures somehow lowers the risk of that loan. In

addition, the Enterprises' representation, warranty and enforcement framework may be more robust than similar frameworks available to banks – for example, an Enterprise has as an enforcement mechanism, a servicer termination right with respect to a servicer's entire Enterprise servicing book; non-Enterprise entities may only have such a right with respect to individual pools or trusts. The loss of a seller or servicer's status as an Enterprise "approved" seller or servicer likely has more dramatic consequences than losing correspondent lender status under non-Enterprise programs, and an entity may go to greater lengths to avoid the loss of Enterprise "approved" status.

This common-sense observation also ignores broader, less idiosyncratic, non-asset level aspects of the entity, and of the portfolio, in which that asset resides. Taking those other aspects into account results in a comprehensive determination of the economic capital needed to support that risk. Other things being equal, from an economic perspective, entities with more diversified risks likely require less incremental capital to hold a particular asset than do entities (like the Enterprises) that essentially hold only a single type of credit risk. The way non-Enterprise entities can, and do, fund their portfolios may be another example of one such broader, non-asset level factor. These broad factors clearly justify different economic capital requirements for non-Enterprise entities, and thus could serve to account efficiently for risk differentials in a non-distortive manner.

To the extent, however, that once the asset-level, entity-level, and portfolio factors are clearly articulated and taken into account, a specified loan can be moved from, say, a bank to an Enterprise, and the result is that a materially different amount of regulatory capital is then required to be held, the opportunity for regulatory arbitrage exists, which is likely to be distortive to the detriment of the system as a whole. This may be of particular significance in the bank-Enterprise context, since both deposit-taking banks as well as the Enterprises are currently supported in the case of stress situations by the United States: depository banks through Section 14 of the Federal Deposit Insurance Act (12 USC §1824(a)), and the Enterprises through the Senior Preferred Stock Purchase Agreements.

So, at least as between the Enterprises and banks, SFIG is of the view that, subject to appropriate, clearly articulated and justifiable adjustments, a similar regulatory capital treatment should apply at the asset level for the same asset whether held by an Enterprise or by a bank. We feel that this approach would discourage the assumption of mortgage credit risk by the Enterprises, or, for that matter, by banks, in either case for purely regulatory arbitrage benefits.

We also point out that mortgage credit risk could accumulate at the Enterprises for reasons other than the effect of the capital requirements, for example, due to g-fees and "cross-subsidization". These other aspects of the Enterprises' operations may also need to be examined, since even with the same capital requirements between banks and the Enterprises, there may still be increased accumulation of mortgage credit risk at the Enterprises. Thus, g-fee policy and other limits on Enterprise activity may still be required, even with a level playing field for capital, to limit risk at the Enterprises and maintain competitive equilibrium across the spectrum of mortgage industry participants and products.

To sum up our observations on this point, we think that the Enterprises' capital requirements, as well as other aspects of the Enterprises' mortgage finance programs, should not result in the undue accumulation of mortgage credit at the Enterprises. The best way to accomplish that would be not to have that risk assumed by the Enterprises in the first place, rather than allowing for initial accumulation and a subsequent distribution of that risk. This can be achieved by first examining the capital requirements and other program elements (including in particular the g-fee) through a market-focused lens, making clear that deviations from benchmarks provided by the private sector are justified and clearly expressed.

Further in the same vein, but more specifically, SFIG notes that, although the results as they appear in the look-up tables are transparent and clear, the analysis supporting multipliers in the look-up tables is not fully disclosed, nor is the underlying model made available. Without transparency into the generation of the multipliers in these tables – which form a critical function in the ultimate capital calculation for the Enterprises – industry participants will be unable to evaluate differences in credit risk that appear to be dependent upon the institution holding the risk. Additionally, such lack of transparency obfuscates distinctions between capital regimes at different regulators, and may lead to additional opportunities for capital arbitrage.

The CRT Program Has Been Beneficial to the Enterprises, and the Regulators Should Encourage the Expansion of Risk Transfer Including, but not Limited to, the CRT Program

This observation is addressed to both the FHFA as well as to the Department of the Treasury/Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve (the "Banking Agencies"), each of which is copied on this letter.

As we and other industry commenters have noted, the CRT program, and in particular its capital-markets focused approach (STACR and CAS) have not only served the FHFA's purpose of distributing risk away from the Enterprises (and, by extension, from the taxpayers) and to the private markets, the program has also met a need for an opportunity for private markets to invest in mortgage credit. As we said in our 2016 CRT Letter and as noted above, we support the proposition that the CRT program should be a permanent feature of the Enterprises' risk management strategies, and that appears precisely to be the FHFA's view as well.

Following on our themes from the prior point regarding the desirability of a "level playing field" among entities subject to regulatory capital requirements, we observe here that this very effective risk distribution tool, while proposed to be adopted with respect to the Enterprises, remains underutilized by U.S. banks, and private market innovation to accomplish the same result has been minimal. Further, it appears to SFIG that the corresponding rules proposed in the European Union, the "Significant Risk Transfer" ("SRT") rules, are more encouraging of CRT-type transactions that may be undertaken by E.U. banks. Thus, U.S. banks may be put at a competitive disadvantage not only to the Enterprises, but also to E.U. banks.

U.S. banks can attempt to achieve risk transfer in primarily three ways: traditional cash securitizations, synthetic securitizations, and privately-issued risk transfer securities. All of these

approaches, however, have substantial obstacles in their implementation, which have prevented these techniques from being widely adopted.

With respect to traditional cash securitizations, current regulations provide for "operational criteria" that include, among other things, that the purported transferred assets cannot continue to be reported on the bank's GAAP balance sheet. U.S. GAAP generally prevents U.S. banks from de-recognizing securitized assets of a bank, with the result that these transactions generally do not result in capital treatment relief with respect to those assets.

The U.S. regulatory rules for synthetic securitizations on their face appear more promising, since they do not contain the "true sale" requirement (as the assets, by design, stay on the balance sheet). However, these rules, in practice, have proven to be almost too open-ended, leaving the requirements for capital relief open to interpretation both by the bank undertaking the transaction as well as the regulators. In addition, these synthetic structures may pose, probably inadvertently, issues under the commodity pool regulations of the Commodities Future Trading Commission, as well as under the Volcker Rule. Were final regulations to be adopted under Section 621 of the Dodd-Frank Act, these transactions may well also run into difficulty under the Conflicts of Interest provisions of Section 621.

In addition, the U.S. regulatory rules for bank capital requirements do not contemplate securities that increase in value during times of market stress. Privately issued risk transfer securities that provide a hedge against a decline in the real estate market and are countercyclical to mortgages do not receive credit in line with what is being proposed for CRT securities issued by the Enterprises.

Thus, in general, the U.S. regulatory regime has had the overall effect of disincentivizing CRT-type programs for banks, which in and of itself may promote the accumulation of mortgage credit risk in the Enterprises, since they have access to an extremely efficient risk-management tool that U.S. banks do not.

This lack of a level playing field is further extended and compounded by the E.U. developments in SRT, which many commenters believe is a more consistent, quantifiable approach as compared to the U.S. capital relief rules.

In this regard SFIG's recommendation is that the U.S. banking agencies undertake to modernize the U.S. capital relief rules under 12 C.F.R. 217.41, bringing them more in line with those proposed for the Enterprises and the SRT rules proposed for the E.U.

Countercyclicality

We note that a major feature of the Proposed Rule is that it would use "mark to market loan-to-value" ("MTMLTV") ratios in the look-up grids to determine asset-level credit risk. This would be a substantial change from the way the Enterprises have historically evaluated credit risk as well as the way banks are required to evaluate such risk – in both of these cases, the original loan-to-value has been used. This change would then lead to a dynamic calculation of credit risk and thus of the required level of capital, as it would take into account movements in home prices since loan origination. Depending on the direction of home prices at the time of

measurement, adopting this approach could lead the Enterprises' capital requirements to move either up or down, and to fluctuate over time, for a given loan or pool of loans.

We at SFIG certainly recognize the merits of an approach using MTMLTV. As the FHFA notes in the Proposed Release, ". . . current (refreshed) credit scores and [MTMLTV] are the two primary drivers of credit losses in performing seasoned loans . . ." – a statement with which we agree. However, we also recognize that adopting the MTMLTV approach would, in isolation, produce a strongly pro-cyclical bias in the Enterprises' capital requirements: higher house prices during good times lead to more guaranty capacity, while lower housing prices during stress periods lead to reduced guaranty capacity.

The FHFA itself acknowledges this result throughout the Proposed Rule's release, and cites to various counter-cyclical elements of the overall proposal, most importantly the minimum leverage requirement and the capital buffer. We agree that these provisions are countercyclical and do serve to diminish the concern.

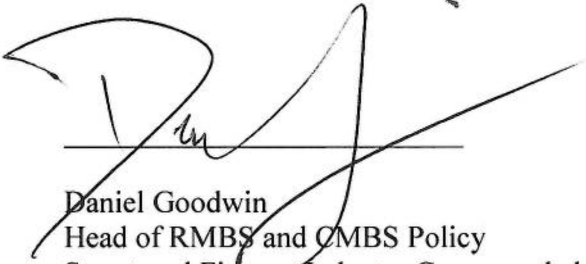
However, SFIG does see the pro-cyclicality of the proposed risk-based capital framework as a major topic for further discussion since, experience has demonstrated that the effect of stress periods can sometimes overwhelm even the most carefully and thoughtfully developed frameworks. We suggest that the Enterprises examine ways to expand the risk transfer program into more countercyclical processes as a way of counterbalancing pro-cyclical bias. We note that both Enterprises' charters (which are Federal statutes) declare, as the first-enumerated purpose of each Enterprise, to "provide stability in the secondary market for residential mortgages". The need for the Enterprises to provide stability is of course never greater than during times of stress, when private capital generally engages in the so-called flight to quality, which is likely to mean increased demand for Treasuries and Agencies (such as the Enterprises' guaranteed MBS) and away from PLS and probably also away from STACR and CAS.

So, on this last point we deviate from our usual support for a level playing field, since in this case we agree that a government backstop is probably necessary, and that guaranty capacity needs to be maintained.

In addition, we feel that as a general matter countercyclicality is best addressed by express regulatory provisions, such as a countercyclical capital buffer, rather than through the FHFA's statutory discretionary authority to establish and adjust capital requirements. We acknowledge that, particularly of course in times of stress, "exigent circumstances" may require a level of discretionary action. But, in the interests of transparency, that should be a last resort, and not a structural element of the capital requirements.

SFIG and the Task Force again thank the FHFA for the opportunity to submit these comments on the Proposed Rule. Please contact Daniel Goodwin at 202.524.6303 or Daniel.Goodwin@sfindustry.org to address any of the points raised in this letter.

Respectfully Submitted,



Daniel Goodwin
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Structured Finance Industry Group, on behalf of the Task Force

cc: Thomas Curry, Comptroller of the Currency, Office of the Comptroller of the Currency
Jelena McWilliams, Chair, Federal Deposit Insurance Corporation
Craig Phillips, Counselor to the Secretary, U.S. Department of the Treasury