



November 15, 2018

Mr. Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
Constitution Center
Eighth Floor
400 7th Street, SW
Washington, DC 20219

Attn: Comments - RIN 2590-AA95 – Proposed Rule on Enterprise Capital Requirements

Dear Mr. Pollard:

Fannie Mae appreciates the opportunity to comment on the Federal Housing Finance Agency’s (“FHFA”) Proposed Rule on Enterprise Capital Requirements (the “Proposed Rule”).¹ We believe the creation of a more robust capital regime for the Enterprises and any future housing finance entities covered by the Proposed Rule (collectively, the “Regulated Institutions”) is necessary and agree that appropriately sized and risk-sensitive capital standards will help safeguard the housing finance system. We also commend FHFA’s stated aim of ensuring that risk-adjusted capital levels for the Regulated Institutions remain effective in all market conditions to help support a sustainable and reliable housing finance business model.

In order to source private capital to support the business model, any Regulated Institution will need to produce an acceptable return on risk. The drafting of the capital rule should enable appropriate risk-based investments from both equity and credit risk transfer investors.

Although the final rule will only go into effect post-Conservatorship, we will begin working with FHFA during conservatorship to align our business to the new capital requirements. Additionally, we will continue to support FHFA’s efforts on the development and implementation of the Conservatorship Capital Framework Standards, which intersect with the terms and provisions of the Proposed Rule.

We appreciate FHFA’s balancing of risk-based considerations with the need for simplicity and transparency in key areas of the Proposed Rule. Our recommendations focus on areas of the Proposed Rule where amendments could enhance transparency, resiliency, and stability. We organize our comments into the following sections:

- I. Capital Stability and Certainty
- II. Multifamily Market Risk Capital Treatment
- III. Going-Concern Buffer

¹ Notice of Proposed Rulemaking, “Enterprise Capital Requirements,” 83 Fed. Reg. at 33,312 (July 17, 2018).



- IV. Leverage Ratio
- V. Extent of Regulatory Discretion
- VI. Additional Areas of Comment

Summary of key observations and recommendations

We agree with many elements of the Proposed Rule, and we recommend a series of changes that, if incorporated, should further support a housing finance system capable of surviving severe downturns, providing a stable source of liquidity through *all* markets, and attracting private capital by providing returns consistent with investor expectations.

We believe that the Proposed Rule should incorporate the following suggestions:

- **Apply original loan-to-value ratios and original FICO scores for single-family loans and original loan-to-value ratios and original Debt Service Coverage Ratios for multifamily loans to promote stability and certainty in credit risk capital measurements:** In its proposal, FHFA acknowledges that elements of the Proposed Rule may have procyclical impacts and could amplify prevailing economic and credit conditions in both strong and worsening housing markets. We share those concerns, specifically around the Proposed Rule’s use, for credit risk capital calculations, of mark-to-market loan-to-value ratios (“MTM LTV”) and current FICO scores for single-family loans and MTM LTV and updated Debt Service Coverage Ratios (DSCR) for multifamily loans (together, the “MTM Approach”).²

We believe that the MTM Approach could cause a significant increase in a Regulated Institution’s capital requirements during housing market downturns. This increase in capital requirements would occur when the Regulated Institution’s ability to generate sufficient earnings to support those requirements is declining and new sources of capital may be unavailable. Conversely, in periods of housing growth, capital requirements would decline, potentially reducing incentives for the Regulated Institutions to build capital cushions when they are best positioned to do so.

We estimate that in a severely adverse stress environment, such as that defined in our 2018 Dodd-Frank Act Stress Test (“DFAST”), our risk-based capital requirement would increase by approximately 80 percent for the entirety of our book, equaling nearly six percent of total assets. To understand the impact on any future housing finance entities covered by the Proposed Rule, we isolated the impact to our single-family performing loans. We estimate the capital required for single-family performing loans would also rise by almost 80 percent during the stress scenario. To ensure adequate capital in such a scenario, any Regulated Institution would need to hold a sizeable capital surplus during more normal economic environments. The need for such a surplus is real, because consistent with their mission, the Regulated Institutions must maintain a constant presence in the housing market and would want to avoid being forced to raise capital in times of stress. The significant increase in capital to build a surplus would require commensurate rises from today’s guarantee fee-pricing.

² Proposed Rule at 33,332.



Rather than use an MTM Approach, we recommend that the Proposed Rule use the original loan-to-value (“OLTV”) ratio and original FICO (“OFICO”) score for single-family loans and OLTV and original DSCR (“ODSCR”) for multifamily to establish capital factors (together, the “Origination Approach”).³ The Origination Approach would have the Regulated Institutions maintain higher capital requirements in periods of normal economic conditions and sustained home price appreciation. The result is that in benign economic conditions, such as today, there would be more total capital in the system than implied by the Proposed Rule. For example, we calculate that the adoption of the Origination Approach would increase our capital requirement today, compared to the MTM Approach, by nearly \$25 billion.

At the same time, this approach would increase the stability of capital requirements during periods of home price depreciation and economic stress. While the Origination Approach would still necessitate an increase in guarantee fees to achieve suitable returns on capital, the increase would be less than that required under the MTM Approach and would provide greater stability in guarantee-fee pricing throughout economic cycles.

Our concerns about procyclicality are based on the assumption that the Regulated Institutions should be reliable sources of liquidity, with stable guarantee fee pricing, in all markets at all times. Our analysis implies a significant reliance on equity capital to meet regulatory capital requirements and ensure the Regulated Institutions’ ability to provide consistent liquidity at attainable pricing levels.

Credit risk transfers, of the type that the Enterprises have facilitated since 2013, are another potential tool to mitigate procyclical effects. We caution that the reliance on such markets as a continuous source of risk capital and the cost and availability of such insurance is susceptible to disruption during times of market stress. An over-reliance on these markets could make it difficult for the Regulated Institutions to ensure capital compliance and to remain a stable source of mortgage liquidity in a severe downturn.

- **Adjust the multifamily market risk component to treat multifamily whole loans and MBS equally:** The Proposed Rule attributes different market risk spread shocks for multifamily whole loans (15 bps) and multifamily MBS (100 bps). Given that the terms of the underlying loans are structurally unchanged by securitization, we do not believe that the securitization of multifamily whole loans into multifamily MBS increases the market risk of the underlying asset as the spread shock differential suggests. Since today’s Enterprise-issued MBS are liquid and tradeable assets, we recommend that the spread shocks for multifamily MBS and multifamily whole loans be equivalent, or that the MBS receive a lower spread shock, under the Proposed Rule.

³ Our recommendation is to hold both LTV ratios and FICO scores constant for single-family credit risk capital calculations. For multifamily loans, FICO scores are not applicable, and our recommendation is to hold the LTV ratio and the DSCR constant.



- **State the terms under which a Regulated Institution may use the going-concern buffer in a period of market stress:** We believe the proposed 75 bps going-concern buffer of the market value or unpaid principal balance for assets, as applicable, is appropriate. We recommend that the Proposed Rule specify the terms under which a Regulated Institution may draw upon the going-concern buffer and stipulate the regulatory consequences of making such a use. Unambiguously permitting the use of the going-concern buffer in the rule is consistent with capital regimes applied to banks and would allow the Regulated Institution to better assess resources available for stress conditions. Permitting the use of the buffer would also mute the volatility introduced by the adoption of the Current Expected Credit Loss (“CECL”) accounting methodology.
- **Adopt the bifurcated leverage ratio to ensure continuity of incentives to transfer risk:** In the Proposed Rule, FHFA requests comment on the use of either a bifurcated or fixed leverage ratio. We recommend the use of the bifurcated leverage ratio and believe the alternative fixed leverage approach does not provide the appropriate risk-management incentives. If the fixed approach were to be adopted, the leverage ratio could become the binding capital constraint for Fannie Mae almost immediately, thus reducing incentives for the Regulated Institution to transfer credit risk to private investors and other counterparties.
- **Provide greater certainty on how FHFA intends to apply regulatory discretion related to capital management:** We believe that well-defined capital standards provide greater transparency and predictability for the Regulated Institutions and their stakeholders, and help to promote robust capital management practices. We therefore recommend that FHFA detail specific measures or triggers that would prompt potential regulatory capital intervention. Only under the most rare and unusual circumstances should discretion be used, or market confidence in the capital regime could be impaired.
- **Modify the risk-based capital requirements for other assets and guarantees:** The Proposed Rule allows Regulated Institutions to apply their own internal methodologies to calculate preliminary risk-based capital requirements for unassigned activities. We recommend that the Proposed Rule allocate a fixed capital charge for these assets to promote consistency and comparability of capital calculations among Regulated Institutions.

I. Capital Stability and Certainty

A. Credit Risk Calculation Methodology in the Proposed Rule

In Question 3 of the Proposed Rule, FHFA invites comment on periodic risk-based updates to credit risk capital calculations, particularly since this approach could lead to volatile capital requirements that contribute to exacerbating prevailing market conditions. In the discussion that follows, FHFA inquires if it should consider alternative risk-based capital approaches,



including holding housing price assumptions for loan-to-value ratios (“LTVs”) or other risk factors constant to avoid procyclical effects.

Discussion

We are concerned that the proposed credit risk capital requirements could introduce significant capital and guarantee pricing volatility, overly incentivize excessive risk taking in strong housing markets, and reduce market liquidity in periods of stress. FHFA itself recognizes the potential associated risk of procyclicality when it writes, “In times of house price appreciation mark-to-market LTVs would fall and credit risk capital requirements would decrease, while in times of house price depreciation mark-to-market LTVs would rise and credit risk capital requirements would increase.”⁴

Using the severely adverse stress assumptions from the 2018 DFAST and assuming our ability to transfer credit risk would be limited because of the high cost or lack of available capital during the stress, we estimate that under the proposed MTM Approach, our risk-based capital requirement would increase by approximately 80 percent and would require a commensurate increase in pricing, consistent with investors’ return expectations. The ending minimum capital requirement under the scenario would be approximately \$187 billion, or 5.8 percent of total assets.

The procyclical impact of the MTM Approach would not just apply to legacy Enterprises, but any Regulated Institution covered by the Proposed Rule. To understand the potential impacts on a new entity, which would likely have a book of business consisting primarily of performing loans, we assessed the procyclical impacts of the MTM approach on different segments of our guarantee book. We found that the increase in capital for single-family performing loans, net of credit risk transfer, is the largest driver of the capital increase under the severely adverse DFAST assumptions. The capital required for single-family performing loans would also rise by almost 80 percent in the severe DFAST scenario. (See Appendix 1 for analysis.)

To ensure capital adequacy in periods of stress, the prudent management action would be to hold a sizeable capital surplus above the minimum regulatory capital requirement in preparation for a severe downturn for three reasons. First, raising significant amounts of additional capital from private sources in a stress environment would be difficult, if not impossible, given market constraints. Second, the alternative to raising capital—the large-scale divestiture of assets—could be similarly infeasible, because it would likely accelerate price declines and run contrary to our role as a stabilizing force in the housing finance system. Finally, during a severe downturn, Regulated Institutions would have limited opportunity to accumulate capital through earnings, as credit related losses flow through the income statement.

⁴ Proposed Rule at 33,332



While having a capital surplus is best practice, the magnitude of the surplus required here would be substantial and comes with significant cost. As previously stated, we expect that to attract capital to achieve this level of surplus, we would need to offer investors a sufficient return on that capital. The primary mechanism for a Regulated Institution to generate returns is through the guarantee fees that it charges to single family and multifamily MBS. Absent any changes in the rule, these guarantee fees for a new entrant would need to increase at levels proportionate to the additional 80 percent surplus suggested under the MTM Approach during a severe stress scenario.

Our concerns about procyclicality are based on the assumption that the Regulated Institutions should be reliable sources of liquidity, with stable guarantee fee pricing, in all markets at all times. Therefore, our above analysis implies a significant reliance on equity capital to meet regulatory capital requirements.

Credit risk transfers are another source of capital in the system. The Proposed Rule recognizes this source and gives, in our view, appropriate capital relief for credit risk transfers.⁵ An over-reliance on credit risk transfers, however, could have consequences for market stability and guarantee pricing in times of stress. During a national economic downturn, there may not be sufficient third-party demand for mortgage credit, or during periods of regionalized stress, credit risk transfer investors may be unwilling to increase risk exposure in the affected regions. Under any market disruption, credit risk transfer investors are likely to charge much higher costs for this risk exposure. The Regulated Institutions would need to pass through those costs in the form of higher guarantee fees or stop providing liquidity.

Recommendation

We request that FHFA establish credit risk capital factors based on OLTV ratios and OFICO for all single-family loans and establish OLTV and original DSCR for all multifamily loans for the lifetime of these loans. This change will better enable Regulated Institutions to meet their charter requirement to provide liquidity to mortgage markets during and after a period of stress.⁶ Under the Origination Approach, the capital factors based on the relevant (performing, non-performing, and reperforming) look-up grid would be held constant, but the amount of required capital would be reduced as the loan pays down over time, or would increase if it enters various states of delinquency.

We see a two-way stabilizing benefit of the Origination Approach. First, in periods of home price appreciation, the Origination Approach would help mute the MTM LTV benefit and would require the Regulated Institutions to hold more capital when they have full earnings power. For example, we calculate that the adoption of the Origination Approach would increase our capital requirement today, compared to the MTM Approach, by nearly \$25 billion.

⁵ Based on our reading of the Proposed Rule, similar credit risk transfers for single-family and multifamily would receive similar capital treatment.

⁶ Proposed Rule at 33,334.



Under the severely adverse stress scenario from the 2018 DFAST, we estimate that our risk-based capital requirement using the proposed Origination Approach would be approximately \$127 billion or nearly four percent of total assets (compared to \$187 billion or 5.8 percent of total assets required under the MTM Approach). While this could require an increase in single-family guarantee fee pricing, the impact would be significantly muted compared to that under the MTM Approach.

The MTM Approach measures the risk of the balance sheet through time and adjusts capital requirements to reflect changes in the housing market and in borrower credit worthiness, both of which are outside the Regulated Institutions' control. Unlike a securities-trading book, such as you would see at a typical broker-dealer firm, the loan exposures acquired by the Regulated Institutions are managed over the long term. There is limited, if any, practical way to "take a loss" and eliminate the loan balances completely to reduce the increasing capital requirement in a stress environment. Credit risk transfers may offer a partial solution, but it is unclear how useful this tool will be in a stress scenario.

We note that the base credit risk tables were calculated to determine the amount of capital necessary to absorb losses in a severe housing crisis, such as was seen in the past decade. In addition, a going-concern buffer has been added to the minimum risk-based requirement. Requiring additional capital as stress conditions emerge may not fully reflect the fact that adequate capital was reserved for the stress at the time of acquisition.⁷

Adopting the Origination Approach will reduce the significant complexity involved in complying with the Proposed Rule. Greater simplicity should facilitate better capital planning, reduce internal model dependence (in relation to the MTM Approach that requires periodic updates), and support effective regulatory oversight. We believe that the Origination Approach should apply across all capital grids, because the capital treatment for non-performing loans (NPL) and for reperforming loans (RPL) is significantly higher than that required for performing loans and is not particularly risk-sensitive to LTV and FICO changes. (See Appendix 2 for analysis.)

B. Accounting Methodology Effects on Capital Stability and Predictability

The Regulated Institutions must adopt Current Expected Credit Loss ("CECL") accounting methodology for their financial statements beginning January 1, 2020. The introduction of CECL will likely exacerbate the procyclical impacts of the Proposed Rule by accelerating the recognition of losses. As a result, the Regulated Institutions would have less capital available to meet rapidly increasing requirements imposed by the MTM Approach's impact during severe housing market downturns.

⁷ The Proposed Rule applies a capital charge for single-family loans at the time of acquisition that would be sufficient to cover losses up to a 25 percent housing price decline. (Proposed Rule at pg. 33,336.) Consequently, if a home experienced a 10 percent decline in value and the capital charge were updated to reflect the new LTV, the capital level would effectively be covering a 35 percent home price decline.



Under CECL, financial institutions must calculate their allowance for loan losses based on forward-looking projections, among other considerations, of expected loss over the lifetime of a mortgage asset. This represents a significant change from the current “incurred loss” accounting methodology, where the allowance for loan losses on mortgage loans is based on shorter-term projections where loss realization is deemed “probable.” At present, Fannie Mae applies the incurred loss methodology to approximately 90 percent of the applicable loan population.

We assessed the impact of CECL on available capital using the severely adverse scenario from the 2018 DFAST and using our current working assumptions on CECL implementation, as of July 2018.⁸ As a baseline, using today’s incurred loss approach for calculating our allowance for loan losses and assuming a 30 percent housing price decline, we would expect our loss reserves to increase by \$17 billion, reducing our capital base by the same amount. In contrast, using the same assumptions, holding all other variables constant, but applying the CECL methodology, the loss reserve allowance could increase approximately four-fold from today’s levels, reducing our capital base by over \$60 billion.⁹

While additional credit risk transfers can reduce the potential impact from CECL, as discussed earlier in Section I, Regulated Institutions’ over-reliance on credit risk transfer may challenge their ability to provide liquidity to the housing markets in all market environments.

Recommendation

As we note above, the prudent management response to the MTM Approach under the Proposed Rule would require us to increase our capital base to levels well above those required to sustain operations through a severe and sustained stress scenario, such as the last housing crisis. The application of CECL would simultaneously reduce available capital in times of stress as capital requirements increase, driven primarily by the MTM credit risk calculations. Consequently, as we describe above, the change to CECL accounting heightens the importance of reducing the procyclicality associated with the Proposed Rule, such as through adoption of the Origination Approach.

While FHFA does not control the setting of accounting guidance, we note that banking regulators, including the Federal Reserve Board, OCC, and FDIC, are working to develop clarifying and consistent guidance around CECL implementation for financial institutions. We request that FHFA consider emerging guidance that is being developed around CECL by other financial regulators to establish the Regulated Institutions’ implementation requirements for

⁸ Our CECL working assumptions may differ from the final implementation, and any changes would impact the estimate.

⁹ Based on DFAST 2018 severely adverse scenario and assumptions, reflecting realized housing price decline through MTM LTV, as well as continued housing price decline in the forecast. A small portion of the allowance increase may be offset by higher CRT benefits depending on the CRT structure; the majority of the loans in the guarantee book still do not have an associated CRT benefit, though this percentage will increase over time as CRT use expands.



CECL and to consider interactions between CECL, the Proposed Rule, and the Regulated Institutions' stress-testing requirements.

II. Multifamily Market Risk Capital Treatment

In Question 24 and Question 25 of the Proposed Rule, FHFA invites comment on the proposed approach for calculating market risk capital requirements for multifamily whole loans and multifamily mortgage-backed securities ("MBS"), respectively.¹⁰

In calculating the market risk for multifamily assets, the Proposed Rule focuses on spread risk arising from the probability of the devaluation of such assets. The discussion in the Proposed Rule notes that the market risk calculation does not consider the interest rate risk because the Regulated Institutions hedge such risk at the portfolio level.¹¹ In the proposed market risk calculation for multifamily assets, the Regulated Institutions are required to multiply the asset's market value (or estimated fair value if market value is not available) and a capital charge that is calculated based on a specified spread shock and a duration value generated by the relevant Regulated Institution's internal model. The assigned spread shocks in the Proposed Rule are 15 bps for multifamily whole loans and 100 bps for multifamily MBS.¹²

Discussion

We do not believe that there should be a lower spread shock for multifamily whole loans than for multifamily MBS. The Proposed Rule requires a near sevenfold increase in market risk spread shocks when a whole loan is transformed into a multifamily MBS, and attributes this variance to "the complexity of the structured [multifamily MBS] products relative to whole loans which could decrease liquidity and increase cash flow pricing sensitivity to changes in interest rate spreads."¹³ However, we note that Fannie Mae multifamily MBS are typically simple pass-through securities, with each security comprising one underlying multifamily loan that carries a guarantee.

Our historical experience has been that multifamily whole loans are **less liquid** than multifamily MBS. To underscore the market's view of the liquidity of today's Enterprise-guaranteed multifamily MBS, it is worth noting that they are widely accepted as collateral for secured borrowings, including for bilateral repo transactions.

We are concerned that the Proposed Rule, by specifying a market risk spread shock for multifamily MBS that is greater than the market risk spread shock for multifamily whole loans, does not appropriately align risks with capital requirements.

¹⁰ Proposed Rule at 33,373–33,374.

¹¹ *Id.* at 33,373.

¹² Market risk is distinct from credit risk, which is captured by other elements of the Proposed Rule, and is only meant to reflect changes in an asset's value influenced by market factors.

¹³ Proposed Rule at 33,374.



Recommendation

We request that the Proposed Rule set, at minimum, an equivalent spread shock for multifamily guaranteed MBS and multifamily whole loans and preferably consider a lower spread shock for multifamily MBS than for whole loans. This is consistent with the US Treasury’s recommendation that regulations for securitized products should reflect the “capital required to hold the same disaggregated underlying assets” and “neither encourage nor discourage funding through securitization.”¹⁴

III. Going-Concern Buffer

In Question 5 of the Proposed Rule, FHFA invites comments on the proposed going-concern buffer of 75 bps as a fixed capital requirement on the unpaid principal balance of instruments with credit risk or on the market value of instruments with market risk. Additionally, FHFA solicits recommendations for alternative approaches and modifications. FHFA notes that the going-concern buffer is intended to have a counter-cyclical impact and allow a Regulated Institution to continue to purchase loans and maintain market confidence during a period of severe distress.¹⁵

Discussion

Fannie Mae believes that the proposed going-concern buffer both ensures robust capital levels and mitigates procyclicality in risk-based requirements during periods of sustained economic and financial growth. We believe that at 75 bps, the buffer is appropriately sized. However, we are concerned that the Proposed Rule does not specify the terms under which a Regulated Institution could utilize the going-concern buffer and the regulatory consequences of such use.

In the Proposed Rule, FHFA states that banking capital requirements and the Basel Accords serve as reference points for the proposed capital requirements.¹⁶ We note that banking regulations generally set forth terms under which a regulated financial institution may access a buffer during a stress event, as well as the consequences of falling below the required buffer level. For example, if a bank breaches the buffer, it usually becomes subject to regulatory actions and limits, including on the institution’s ability to make distributions to shareholders and heightened regulatory scrutiny of management’s decisions.¹⁷

We believe that adding a similar clarification in the Proposed Rule around the use of the going-concern buffer would allow the Regulated Institutions to develop more detailed capital plans and to better understand their available sources of capital during stress events. Furthermore, the ability to draw on the buffer could further dampen the potential for the Proposed Rule’s

¹⁴ See U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities: Capital Markets (October 2017), available at: <https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf>

¹⁵ Proposed Rule at 33,334.

¹⁶ *Id.* at 33,321–33,322.

¹⁷ See 12 CFR § 3.11.



risk-based requirements or the introduction of CECL to compound market stress during a severely adverse scenario.

Recommendation

We recommend that the Proposed Rule be clarified to include the circumstances under which a Regulated Institution could draw down on its going-concern buffer in times of stress, as well as the resulting regulatory implications.

IV. Leverage Ratio

In Questions 29-34 of the Proposed Rule, FHFA seeks comment on two proposed leverage ratio approaches. The first leverage ratio option in the Proposed Rule is to apply a fixed 2.5 percent capital charge for total assets, including those that are off-balance sheet (the “fixed approach”).¹⁸ The second option is to apply a 1.5 percent capital requirement for mortgage assets held in trusts and a 4 percent capital requirement for all other assets (the “bifurcated approach”).¹⁹

Discussion

We support the inclusion of a suitably calibrated leverage ratio as an element of capital regulation for the Regulated Institutions. As with regulatory leverage ratios in the banking sector, a leverage ratio for the Regulated Institutions would serve as a useful backstop to ensure adequate capitalization during periods of housing appreciation. However, we believe that the application of the leverage ratio should be tailored to reflect the specific exposures of the Regulated Institutions, while reinforcing FHFA’s policy objectives (particularly around risk management incentives and requirements on credit risk transfers).

We view the proposed bifurcated leverage ratio as getting that balance right. First, the assets held in trust have fundamentally different risk characteristics than assets held outside the trust. While we believe that the backstop leverage ratio requirement for both trust and non-trust assets should be fixed, the requirement should reflect this fundamental difference between these asset portfolios. By definition, our trust assets are match-funded with financing provided by third parties. As FHFA states, “The funding for these [trust] assets has already been provided and cannot be withdrawn during times of market stress.”²⁰ To the extent that funding is not available through the issuance of MBS, the assets would not exist.

Second, we are concerned that when combined with the procyclical impacts of the MTM Approach to risk-based capital, a uniform 2.5 percent leverage ratio could undermine effective risk management and the policy goal for the Regulated Institutions to share credit risk with investors and other qualified counterparties. In the Proposed Rule, FHFA recognizes the importance of a properly calibrated leverage ratio to ensure that the risk management incentives in the proposed requirements are not rendered less effective.²¹ We believe that the

¹⁸ Proposed Rule at 33,380.

¹⁹ *Id.* at 33,383.

²⁰ *Id.* at 33,326.

²¹ *Id.* at 33,386.



capital management incentives to continue to transfer credit risk to third parties will be disrupted if the Regulated Institutions are held to a leverage ratio that could exceed the risk-based capital standard a significant portion of the time. If the 2.5 percent leverage ratio of the fixed approach were in effect today **and** the MTM Approach remained in effect, our analysis suggests that the leverage requirement could exceed the minimum risk-based requirement for Fannie Mae by the end of 2018 or shortly thereafter.²² In such an event, counter to FHFA’s policy goals, the incentive to transfer risk would be reduced.

Recommendation

We recommend that FHFA adopt the bifurcated leverage ratio in the Proposed Rule. We believe the bifurcated leverage ratio better complements FHFA’s stress-testing requirements and risk-based standards in the Proposed Rule. The bifurcated approach would foster prudent risk-based incentives for Regulated Institution capital management.

In addition, we request clarification in the definition of “trust assets” under the Proposed Rule’s discussion of the bifurcated approach. The Proposed Rule defines trust assets as:

“Fannie Mae mortgage-backed securities or Freddie Mac participation certificates held by third parties, and off-balance sheet guarantees related to securitization activities.”

We believe the definition of trust assets in the Proposed Rule should refer to the loans underlying the MBS, as opposed to the MBS debt obligations themselves, as the leverage calculation is focused on assets, not liabilities. Furthermore, we request that the trust assets definition be inclusive of any accounting adjustments to the loans underlying the MBS (including adjustments related to premiums/discounts and allowances for loan losses).

We recommend that the definition of trust assets be changed to the following:

“Loans underlying Fannie Mae mortgage-backed securities or Freddie Mac participation certificates held by third parties, including any accounting adjustments applied to the loans, and off-balance sheet guarantees related to securitization activities.”

V. Extent of Regulatory Discretion

In Question 38 and Question 39, FHFA solicits comment on the advantages and disadvantages of exercising its regulatory authority to alter the leverage ratio and risk-based capital requirements, respectively, during periods of heightened risk. We believe there are disadvantages to such discretionary interventions, and recommend that such actions be judiciously taken by FHFA.

Discussion

One of the key roles of a Regulated Institution is to serve as a link between the capital markets and the housing finance industry. The cost at which the Regulated Institutions sell their debt

²² This statement is based on Fannie Mae’s observed trends over the last four quarters and is subject to our assumptions about the availability and treatment of DTAs.



and MBS in the capital markets is directly related to the rates homeowners pay for their mortgage loans. Notwithstanding FHFA’s clear existing authority, we are concerned if there was a perception in the capital markets that FHFA might regularly exercise its discretion to alter Regulated Institution leverage or risk-based capital requirements based on prevailing market conditions, the result could be increased costs imposed by private sector investors to compensate for this uncertainty. In contrast to discretionary decision-making, we believe that transparent and well-defined capital expectations, such as those set forth in the Proposed Rule, are the best drivers of optimal risk-management outcomes.

Recommendation

We recognize that FHFA has clear authority to alter leverage and risk-based capital requirements for the Regulated Institutions. We recommend, wherever possible, that FHFA clarify in advance any capital adequacy thresholds, risk-based triggers, or other requirements that it may have for discretionary interventions in Regulated Institution capital standards, especially if these differ from or append the thresholds for Prompt Corrective Action established by the Housing and Economic Reform Act.

VI. Additional Areas of Comment

Below we note areas where added guidance would be helpful to ensure that the Regulated Institutions consistently and appropriately conform to FHFA’s expectations.

Treatment of “Other Assets”

In *Question 27* FHFA solicits comment on the approach in the Proposed Rule for calculating risk-based capital for other assets and guarantees that are designated as “unassigned activities.” The Proposed Rule specifies that for these assets, Regulated Institutions may propose a capital treatment, along with sufficient information for FHFA to assess the proposed treatment, pending further review by FHFA.²³

Discussion

As a general matter, we believe that the Proposed Rule should use specific capital charges whenever possible, as clear regulatory requirements will facilitate consistent application of the final rule and foster transparency and consistency in the Proposed Rule’s requirements. We are concerned that allowing for Regulated Institution-level discretion could lead to divergent capital treatment for similar assets among the Regulated Institutions.

Recommendation

We recommend that FHFA determine an appropriate capital charge that can be applied uniformly to the Regulated Institutions.

²³ Proposed Rule at 33,378.



Highly Liquid Assets

The Proposed Rule defines “cash and cash equivalents” as “highly liquid investment securities that have a maturity at the date of acquisition of three months or less and are readily convertible to known amounts of cash.”²⁴ We are concerned that this definition is under-inclusive and may not cover other highly liquid assets, restricted cash, and accrued interest. We hold such liquid assets as part of our internal liquidity management regime, which contributes to a robust financial risk management structure, and we believe FHFA, similar to other financial institution regulators, should incentivize the Regulated Institutions to hold liquid assets as a means of reducing risk. Banking regulators assign capital charges for cash-equivalent assets based on assigned risk-weights. For example, domestic banking regulators assign a zero percent risk weight to cash owned and held in all offices of the regulated financial institution or that is in transit; T-bills are risk weighted at 0 percent; while certificates of deposit issued by a U.S. depository institution are risk weighted at 20 percent.²⁵

We request that FHFA consider expanding the definition of “cash and cash equivalents” to include the aforementioned assets, which present negligible risk exposures and support our ability to manage our financial risks. We suggest redefining “cash and cash equivalents” more broadly as:

“Highly liquid investment securities that have a maturity at the date of acquisition of three months or less and are readily convertible to known amounts of cash, restricted cash, accrued interest, and additional highly liquid assets designated by FHFA.”

Reverse Mortgage Loans and Securities

The Proposed Rule specifies a 500 bps market risk capital charge for reverse mortgage loans and a 410 bps market risk capital charge for Ginnie Mae reverse mortgage securities. Further, it specifies a 0 bps credit risk charge for both reverse mortgage loans and securities. Although we agree with the Proposed Rule’s comment that “these assets have low and stable market risk resulting from low prepayment sensitivity,” we believe the proposed market risk charges are too large, especially when compared with the market risk charges for other mortgage assets.²⁶

Instead, we recommend FHFA consider revising the total capital charge for reverse mortgage loans to 410 bps, allocating 250 bps to credit risk and the remainder (160 bps) to market risk. As noted in the Proposed Rule, there is Federal Housing Administration insurance on Home Equity Conversion Mortgage (HECM) reverse loans, though that does not entirely eliminate credit risk to loan holders through the lifecycle of the loan. The 250 bps credit risk capital charge reflects the difference between stress scenario and expected scenario losses, based on

²⁴ *Id.* at 33,380

²⁵ Regulatory Capital Rule, 12 CFR § 167.6.

²⁶ Proposed Rule at 33,377



internal net present value models. Lowering the market risk charge to 160 bps provides a charge that is more reflective of the low and stable market risk associated with the loans.

Procedures to Update Capital Requirements

The Proposed Rule requires that the Regulated Institutions use the hard-coded look-up tables prescribed by FHFA to calculate credit risk capital requirements for both our single-family and multifamily business lines. However, we note that the Proposed Rule does not specify the frequency of, or process for, updating such grids. FHFA acknowledges that amending the capital requirements in the Proposed Rule would “generally require soliciting and incorporating public input and would likely be time-intensive.”²⁷

We request that the Proposed Rule include guidance around the process for the review and recalibration of the capital requirements in the tables, including notice periods before updates are implemented, and a defined process for updating fixed inputs to determine capital (including the going-concern buffer). We believe that a well-defined update process in the Proposed Rule would allow for a more stable and predictable capital regime.

Treatment of Alternative Credit Scoring Models

The Proposed Rule anticipates that we use Classic FICO (“FICO”) scores in both the base and secondary credit risk tables for single-family assets. However, we note that the 2018 Economic Growth, Regulatory Reform, and Consumer Protection Act requires that the Enterprises’ consider credit scoring alternatives to FICO.²⁸ The Proposed Rule states that if the Regulated Institutions were to begin using an alternative credit score, or multiple credit scores, the grid for new originations, along with any other grid reliant on credit scores, would need to be recalibrated.²⁹

We request clarity around how Regulated Institutions should treat alternative credit scores for capital purposes given the required calculations. For example, we believe FHFA could distinguish between requiring the Regulated Institutions to use alternative credit scores for underwriting purposes and the use of only FICO to establish credit risk capital requirements.

Borrower Default Events

We note that FHFA currently allows the Regulated Institutions to treat borrower delinquencies that are the result of servicing transfers or natural disasters with some degree of discretion,³⁰ and are concerned that this treatment is not in the Proposed Rule. Absent this discretion, the Regulated Institutions could be subject to punitive capital charges when providing discretionary

²⁷ *Id.* at 33,389.

²⁸ See Section 310 of the Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. 115–174 (2018).

²⁹ Proposed Rule at 33,338.

³⁰ Disaster Relief – Single-Family Selling/ Servicing Frequently Asked Questions (FAQs), Fannie Mae (August 15, 2018), <http://www.fanniemae.com/resources/file/aboutus/pdf/hurricane-relief-faqs-sf-business-partners.pdf>.



forbearance due to administrative changes or borrower hardship, creating a disincentive for Regulated Institutions to provide such support in the future.

In the Proposed Rule, FHFA defines “delinquent” as “one or more missed scheduled payments” and provides for adverse risk-based capital treatment for loans with a history of delinquency.³¹ By contrast, bank regulators apply the same risk-weight for all loans that are less than 90 days delinquent and higher risk weight for delinquencies above this threshold.³²

To retain the flexibility to provide assistance to borrowers, as well as to align our requirements with those of other financial institutions, we request that FHFA consider revising the definition of “delinquent” to mean “three or more missed scheduled payments, or more than 90 days past due.”

Conclusion

Fannie Mae appreciates having the opportunity to comment on the Proposed Rule. If you have any questions or require additional comments, please contact the undersigned at celeste_brown@fanniemae.com. In addition, if you would be interested in speaking with us about our letter, we would be pleased to facilitate that discussion.

Sincerely,

Celeste Brown
EVP and Chief Financial Officer

³¹ Proposed Rule at 33,391; *id.* at 33,342 – 33,349

³² Regulatory Capital Rule, 12 CFR § 167.6

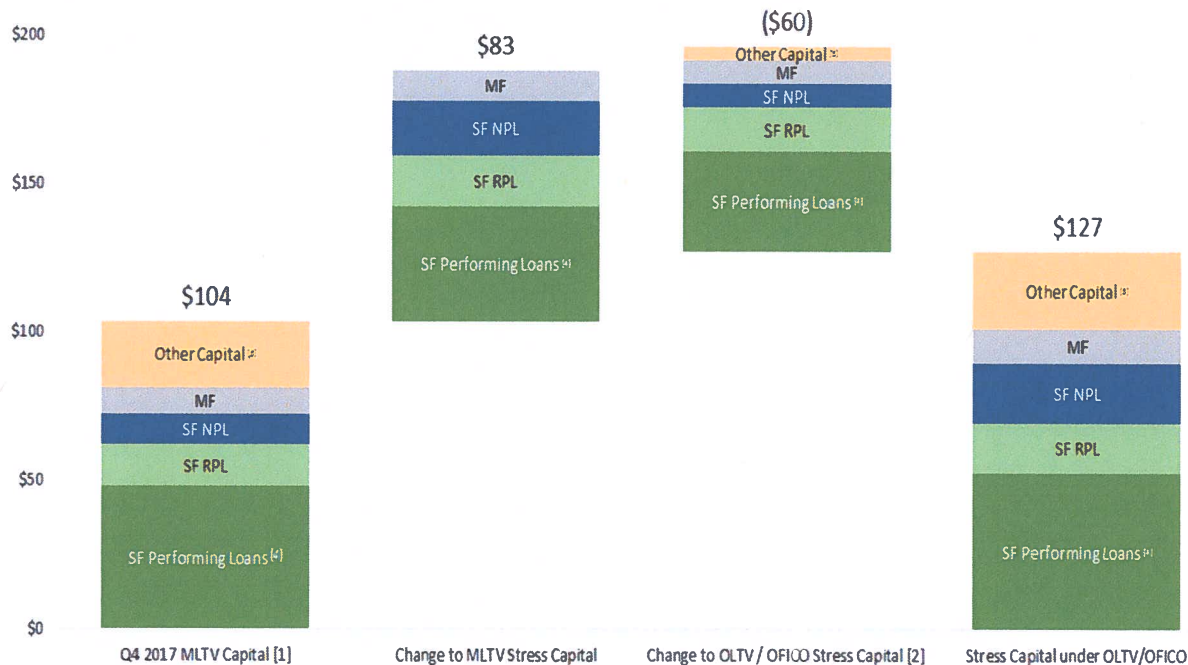


Appendix 1: Impact of the MTM and Origination Approaches on the Fannie Mae book

The MTM and the Origination Approach yield different capital levels at the peak of a stress period. Most of the difference is attributable to the seasoned performing loans. The chart below shows how different parts of the portfolio contribute to the changes in required capital from the start to the peak of a stress. The first bar shows required capital under the Proposed Rule as of Q4 2017. As shown in the second bar, under the MTM Approach, required capital increases \$83B, based on results from the 2018 DFAST Severely Adverse scenario.

Across all portfolio components the increase in required capital is driven by two main factors: 1) deterioration of the LTV/FICO and 2) changes in the performance of the loans and other loan characteristics. The third bar shows the reduction in stress capital under the Origination Approach (from peak levels under the MTM Approach). As shown in the fourth bar, under the Origination Approach stress scenario required capital is \$127B, or \$60B lower than under the MTM Approach.

Stress Scenario Capital Requirements: MTM Approach & Origination Approach



Notes:

[1] Q4 2017 capital reflects the Proposed Rule, inclusive of the Deferred Tax Asset capital charge and a total buffer of 83 bps.

[2] Numbers in parentheses indicate a decline.

[3] Other Capital includes: market risk, DTA capital charge and Assets not covered by the Proposed Rule.

[4] We assume that CRT capital relief is allocated against seasoned performing loans.

Numbers in chart above are subject to rounding. Components not drawn to scale.



Appendix 2: Compliance and capital management issues under the Proposed MTM Approach

Under the MTM Approach, once loans are marked as non-performing loans (NPLs) or reperforming loans (RPLs), complexity is introduced through a two-tiered lookup grid approach, which requires consideration of 20 or more updated risk variables. To demonstrate the responsiveness of loans to changes in risk-factors, we hold LTV and FICO constant below and show capital charge increases for a specific loan after missing payments. We then show how the capital charges vary by LTV for such NPLs.

FHFA Proposed Required Capital By LTV

Capital Required (bps/UPB) ^{1,2}						
Loan Status	LTV range (%)					
	60-70	70-75	75-80	80-85	85-90	>90 ³
Current	154	230	331	405	528	656
1 missed payments	1054	1195	1300	1404	1496	1663
2 missed payments	1233	1374	1462	1535	1612	1695
3-6 missed payments	1315	1437	1503	1556	1600	1638
>=7 missed payments	1565	1619	1650	1659	1667	1577

Increase in Required Capital (%)						
Loan Status	LTV range (%)					
	60-70	70-75	75-80	80-85	85-90	>90
Current						
1 missed payments	584%	420%	293%	247%	183%	154%
2 missed payments	701%	497%	342%	279%	205%	158%
3-6 missed payments	754%	525%	354%	284%	203%	150%
>=7 missed payments	916%	604%	398%	310%	216%	140%

Note:

^[1] Loan assumptions: 680-700 FICO

^[2] Capital required here excludes any multipliers or additional buffers

^[3] FHFA Proposal uses one category for NPLs with LTV>90, which here corresponds to the 90-95 LTV range for performing loans

As the tables above demonstrate, under FHFA's proposed MTM Approach, the movement from the performing to non-performing grids drives the greatest increase in terms of capital. The capital charges for NPLs and RPLs are not especially sensitive to MTM changes, particularly when compared to the large degree of change in requirement when a loan moves from performing to non-performing status.

We also compare that step-up in capital charges for a non-performing loan to the Standardized approach in Basel III for banks and find that the MTM Approach would require a significantly greater multiple of capital on average relative to the banking system.



Required Capital Under Different Regulatory Regimes

Loan Status*	Capital Required (bps/UPB)		Loan Status*	Increase in Req. Reg Capital (%)	
	Basel III	FHFA Proposal		Basel III	FHFA Proposal
Current	400	230	Current		
1 missed payment	400	1,195	1 missed payment	0%	420%
2 missed payments	400	1,374	2 missed payments	0%	497%
3-6 missed payments	800	1,437	3-6 missed payments	100%	525%
>=7 missed payments	800	1,619	>=7 missed payments	100%	604%

* Loan assumptions: 70-75% LTV, 680-700 FICO