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Alfred M. Pollard, General Counsel
Federal Housing Finance Agency
Eighth Floor, 400 Seventh Street, SW
Washington, D.C. 20219
Attention: Comments/RIN 2590-AA95

Dear Mr. Pollard:

Genworth Mortgage Insurance ("Genworth") welcomes this opportunity to submit our comments to the Federal Housing Finance Agency ("FHFA") on the Notice of Proposed Rulemaking ("NPR") for the new regulatory capital framework and alternatives for an updated minimum leverage capital requirement ("Enterprise Capital Framework" or "Rule") for the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") (collectively, the "Enterprises" or "GSEs"). Genworth appreciates the effort and resources FHFA has invested in the NPR, and we commend your objective to provide transparency regarding your Agency's supervisory views.

Genworth has been an insurer of mortgage credit risk for over 35 years, insuring high loan-to-value ("LTV") loans originated and serviced by large and small entities (banks, non-banks, third party originators, and housing finance agencies). We provide loan level mortgage insurance, "bulk" coverage and structured (pool) coverage for the GSEs and other investors. We also engage in a range of structured credit risk transfer transactions analogous to the credit risk transfer ("CRT") structures the GSEs have participated in at your Agency's direction. In the past year, Genworth has insured mortgages for over 170,000 borrowers with median income of $79,000, well over a third of whom were first time homebuyers. Since the financial crisis in 2008, Genworth has helped over 150,000 borrowers avoid foreclosure through loan modifications and other workouts, and during that same time, we paid approximately $8.7 billion in claims, mostly to the GSEs. As one of six private mortgage insurers that satisfy the GSEs' Private Mortgage Insurer Eligibility Requirements ("PMIERs"), Genworth is uniquely qualified to opine on the risk-based capital requirements for the GSEs' single-family mortgage guarantee business, and we will focus our comments on questions related to that area of the Rule.

The stated rationale for the Rule is to "transparently communicate FHFA's views" as to capital adequacy and the capital requirements for the GSEs. According to FHFA, the Rule also will lay the groundwork for capital standards for future housing finance entities.[1] Although capital requirements for the Enterprises have been suspended since they entered conservatorship, we understand that there exists a Conservatorship Capital Framework ("CCF") that was put in place in 2017, and that the CCF was used to inform much of the work on the Rule. We further understand that it is FHFA's intent to require the Enterprises to use the Rule to make pricing and other business decisions and to inform FHFA's views in evaluating Enterprise business decisions while in conservatorship. For this reason,

[1] FHFA and U.S. Department of Housing and Urban Development Enterprise Capital Requirements, 83 Fed. Reg. 33312 (July 17, 2018), available at https://www.gpo.gov/fdsys/pkg/FR-2018-07-17/pdf/2018-14255.pdf.

the Rule could have a material and immediate impact on the housing finance market. Excessively conservative capital requirements could unduly increase the cost of homeownership, especially for first time homebuyers and lower-wealth borrowers.

Genworth has endeavored to provide substantive feedback in this comment letter to the best of our ability based on the information included in the NPR. The key themes we discuss in our comment letter are:

1. **Transparency.** The Rule lacks transparency in many material aspects, which makes it difficult for Genworth to provide the robust and analytical feedback that a rule of this consequence deserves. Genworth urges FHFA to release all data, assumptions, and models that it used to develop the Rule, including the existing CCF, so that we may provide FHFA with the analytical assessment that this undertaking merits.
2. **Regulated Entity Discretion.** FHFA grants significant discretion to each GSE, especially in counterparty ratings and credit for mortgage insurance. Decision-making pursuant to the Rule should be based on publicly available objective criteria. For this reason, Genworth recommends that FHFA delete Table 20 (Counterparty Financial Strength Ratings) and instead use PMIERs as a tool to hold counterparties to the same set of transparent standards.
3. **Procyclicality.** The Rule is procyclical, which could permit the GSEs to release capital as housing markets are peaking and could require the GSEs to attempt to raise new capital during downturns when investors may be scarce and the cost of capital high. Genworth recommends that FHFA implement a methodology to make the Rule operate in a countercyclical fashion.
4. **Bank vs. Insurance Models.** The Rule appears to be based on the Basel III capital standards for banking institutions. An insurance-oriented capital model would be a better starting point in light of the core guarantee business of the GSEs.
5. **Recognition of Guarantee Fee Revenue.** Given the similarity of the GSEs' guarantee business to an insurance business model, the Rule should be revised to recognize guarantee fee revenue on existing guarantee business.
6. **Process.** FHFA should treat the Rule as an Advanced Notice of Proposed Rulemaking ("ANPR") and issue a subsequent NPR that reflects comments received, and that includes all data, assumptions and modeling used to develop the Rule. This will permit Genworth, and other commenters, to provide FHFA with the robust analytical analysis that the Rule merits.

Section One of this comment is a discussion of our observations and recommendations. In Section Two, we provide detailed responses to certain questions in the NPR.

<u>Section One: Observations and Recommendations.</u>

Transparency.

In the narrative accompanying the Rule, FHFA cites transparency as a key objective for the Rule. To accomplish this, FHFA has elected to distinguish risk based on a series of grids (sometimes referred to as look-up tables) and multipliers or haircuts, assessments of counterparty risk, and capital relief due to CRT transactions. However, without access to the existing CCF or the data, assumptions, and models used to develop the look-up tables, it is extremely difficult to assess the appropriateness of the risk weights assigned to mortgages based on their risk characteristics. This opaqueness is compounded by the application of multipliers, such as Counterparty Financial Strength Ratings, that are assigned by each Enterprise based on subjective, discrete GSE assessments that the Rule does not contemplate publishing. Other areas that would benefit from additional transparency include:

1. The Rule applies "risk multipliers" (Table 14) to a base credit grid (Tables 9-13) that generally comports with Genworth's view of loan characteristics that can impact losses and capital. However, it is not clear to us the extent to which certain multipliers correlate to loan performance. Also, we are concerned that the cumulative effect of all the multipliers on loans with stacked risk factors may be more capital than is necessary or appropriate.
2. The Rule was developed using components of risk-based capital rules both for banks and for insurance companies, but we do not know which aspects of which capital regimes FHFA applied, and how FHFA reconciled differences in the approaches.
3. FHFA has used historical loan level data to develop the Rule and to "back test" it against the loss experience of each GSE in 2007, only some of which is publicly available.
4. While look-up tables should be easier to understand and implement than a model-based approach, the application of the tables requires a multi-step process that is complicated to administer.
5. The Rule will apply to the GSEs only *after* they exit conservatorship. However, no decisions have been made about the business model of the GSEs on a post-conservatorship basis, and so Genworth suggests that a better course would be defer further work on a post-conservatorship framework until there is some clarity around the ultimate resolution of the GSEs. In the meantime, we recommend that FHFA leverage the work done for the Rule to further refine the existing CCF (which should be made public).

Regulated Entity Discretion: Counterparty Ratings, Mortgage Risk Concentration, and Credit for Mortgage Insurance

<u>Counterparty Ratings.</u> The Rule grants each GSE significant discretion over the ratings it assigns to counterparties. The Rule requires each GSE to assign a "haircut multiplier" to counterparties that provide credit enhancement. The haircut multiplier depends on a "number of factors" that reflect counterparty risk.[2] Per the Rule, the two main factors driving the multiplier are creditworthiness and mortgage concentration. Financial strength ratings are determined on a one-to-eight scale, and mortgage risk correlation is either "not high" or "high," based on each GSE's view on the counterparty's concentration in mortgage credit risk. Beyond this broad guidance, the Rule fails to provide objective criteria to determine a counterparty's rating. Moreover, the Rule does not require the GSEs to be consistent in how they develop and apply the haircut multiplier, nor does it ensure that FHFA will examine the GSEs' use of factors. This is concerning for several reasons. This lack of transparency could allow the GSEs to assign counterparty ratings to an entity simply to ensure the GSE receives optimum capital credit for a given credit enhancement (or conversely, assign a counterparty a lower rating to justify a business decision to refuse to do business with a counterparty). The Enterprises engage in the same line of business, in the same markets, and during the same cycles,

[2] 83 Fed. Reg. at 33354.

so it is difficult to understand why they should each employ different subjective assessments of risk features such as counterparty strength or mortgage concentration. Leaving counterparties to speculate how to price and capitalize their business to drive higher ratings could have a direct impact on the cost of mortgage credit, and we urge FHFA to reconsider this approach.

Fortunately, there is a readily-available solution to replace the Rule's approach to counterparty ratings: FHFA, in conjunction with the Enterprises, has designed a robust tool for overseeing and evaluating counterparties through PMIERs. PMIERs set capital and liquidity standards for private mortgage insurers, and they provide a framework for operational oversight. Genworth recommends evaluation of all GSE counterparties under PMIERs, which are objective, transparent, and consistently applied by both GSEs. Entities that are PMIERs-compliant would not be subject to any haircut, simply because PMIERs are designed to provide assurance that a counterparty will have the resources and operational strength to meet its claims paying obligations. While the simplest approach would be to require all counterparties to meet the PMIERs standards (recognizing that some modifications may be needed to adapt PMIERs to different business lines), an alternative approach would be to permit the GSEs to engage in some (limited) credit risk transfer with entities that do not satisfy PMIERs, but those entities would be subject to a counterparty haircut.

<u>Mortgage Concentration.</u> As stated in the NPR, the relative risk of banks compared to the Enterprises differ in important ways, including: sources and risk levels of income and assets, differences in funding risk, and the relative exposure to mortgage assets.[3] FHFA notes that the risk assumed by the GSEs related to mortgages is overall less than the risk assumed by banks, because banks invest in whole loans, which expose them to interest rate, market, *and* credit risk, while the GSEs are not exposed to interest and market risk in their core guarantee business. The same is true for private mortgage insurers ("MIs"), which also are exposed primarily to credit risk, and which are experts in assessing mortgage credit risk across cycles.[4] As part of their expertise, private MIs have the capacity to perform an independent credit underwrite on mortgages they insure, which provides added risk protections to the GSEs. As such, the monoline business of counterparties such as private MIs should be considered a positive. Applying a haircut because an MI has a "high" correlation to mortgage assets is punitive and unnecessary, especially in light of the high standards imposed by PMIERs. Moreover, the monoline business model of private MIs give them strong commercial incentives to remain in the market across cycles, because new business insured after a market correction generates premium to rebuild capital that was deployed for its intended purpose of absorbing the shock of a market stress event. The Rule should encourage, not discourage, the use of counterparties with expertise in assessing mortgage credit risk. In addition, the Rule should be grounded in clear, objective and consistent standards applied equally by both GSEs to provide clarity and certainty to counterparties, and to ensure that the GSEs are adequately, but not excessively, capitalized.

<u>Credit for Mortgage Insurance.</u> Genworth's analysis suggests that the Rule significantly understates the benefit of loan level mortgage insurance. As illustrated in Figure 1 below, Genworth evaluated the

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[3] 83 Fed. Reg. at 33323.

[4] Today, private MI insures against a portion of the credit risk, pursuant to contractually defined terms. Among other things, this has the effect of ensuring that mortgage servicers have "skin in the game" if remote losses exceed the amount of MI coverage.

CE Multipliers using a sample set of performing loans with non-cancellable MI that are insured by the Company to “back test” the CE multipliers that would be used to reduce the gross credit risk capital requirements for loans that benefit from loan level credit enhancement.[5] The sample set consisted of loans originated in 2006 and 2007 to evaluate loan performance during a stress period. Our analysis indicates the CE multipliers in the Rule do not recognize the full benefit of loan level credit enhancement. For example, a loan with an original LTV of 90 percent and standard, non-cancellable MI coverage would have a multiplier of 41 percent, meaning that the capital requirement for that loan would be reduced by 59 percent due to the MI coverage. However, our analysis suggests that the capital requirement could be reduced by 70 to 80 percent. This analysis suggests that the GSEs are being required to hold almost twice as much more capital as is needed. Overstating CE multipliers could result in over-priced guarantee fees for low down payment loans. Such an outcome could increase the cost of homeownership, which would be especially challenging for first time homebuyers and lower-wealth borrowers.

Figure 1.

LTV / MI Coverage	CE Multiplier	Genworth Back Test
91-95 LTV 30% Coverage	31%	20-30%
86-90 LTV 25% Coverage	41%	20-30%
80-85 LTV 12% Coverage	71%	40%

Procyclicality.

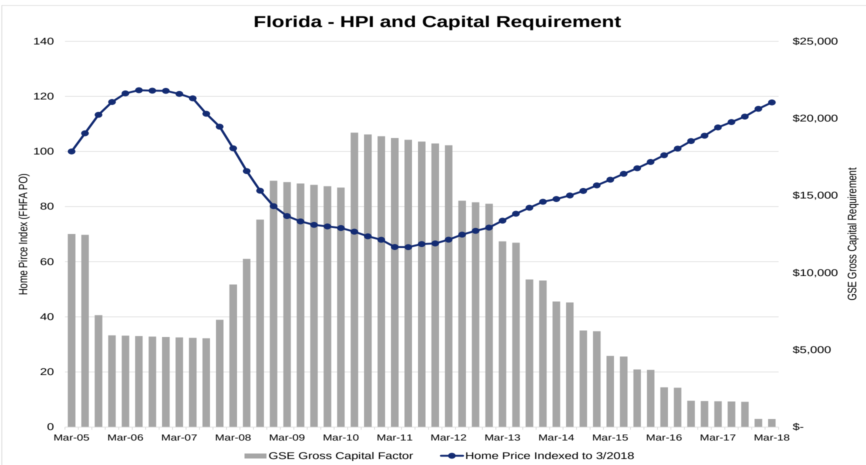
The Rule uses mark-to-market LTVs and current (refreshed) credit scores to refresh the risk-based capital requirements for mortgages held or guaranteed by the GSEs because FHFA is of the view that both features are “primary drivers of credit losses” for performing seasoned loans.[6] These provisions have the combined effect of making the Rule “procycylical” by potentially permitting capital to be released in good times (when borrower credit scores improve, and home equity grows) and increasing capital when markets are under stress. As FHFA acknowledges, the result could be to exacerbate housing market downturns as the GSEs (and their counterparties) likely will be required to (1) raise capital at very high cost, and/or (2) pull back on guaranteeing new business to husband capital. That in turn will put further downward pressure on a housing market that is already experiencing a

[5] 83 Fed. Reg. at 33348-49.
[6] 83 Fed. Reg. at 33336.

downturn and transfer more risk to taxpayers as increased GSE pricing shifts more borrowers in the market to government-insured programs such as FHA insurance.

To demonstrate the procyclical effect of the Rule, Figure 2 below shows the way risk-based capital would have been assessed had the Rule been in effect for a single loan originated in Florida in early 2005.[7] The capital required would have fallen substantially in 2007 (at the height of the run up to the financial crisis), and then would have increased dramatically in 2008-2009, when losses were hitting and capital was scarce.

Figure 2.



Genworth recommends that FHFA consider a countercyclical methodology that would dampen the procyclical impact of the Rule. One possible approach would be analogous to the approach used in the risk-based capital model being considered by the National Association of Insurance Commissioners ("NAIC"). This model makes the amount of capital held for a loan at origination a function of where house prices are relative to long-run trends.[8] This is achieved through differentiating components of required resources by different "markets." These markets are defined each quarter for each U.S. census division and reflect four different potential future home price decline paths.[9]

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[7] Assumes a hypothetical $300,000 30-year, fixed rate mortgage originated in Florida in Q1 2005, interest rate of four percent, LTV 95 percent, and the hypothetical borrower maintains a credit score of 740.

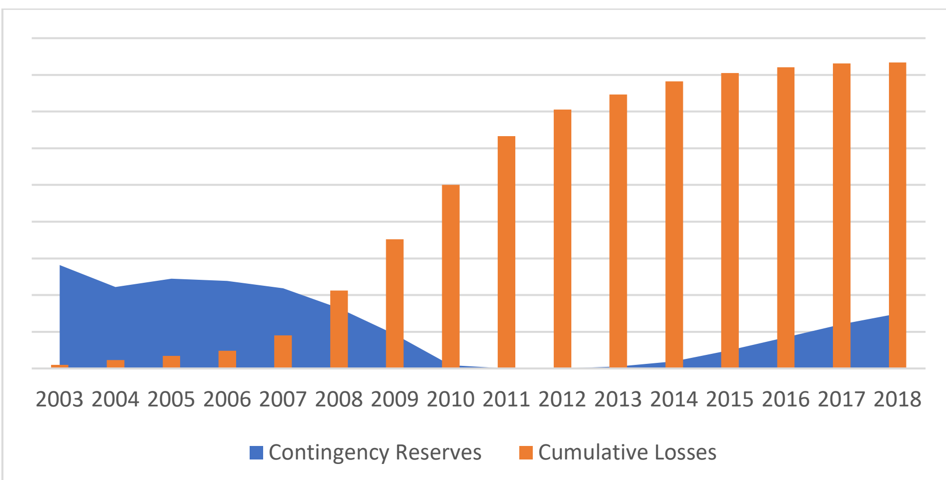
[8] *See* Mortgage Insurance Risk Based Capital: Overview of Proposed RBC Approach (May 9, 2016), available at https://www.naic.org/documents/committees_e_mortgage_guaranty_insurance_wg_expsosure_mirbc_overview_proposed_rbc_approach.pdf?23

[9] The assignment of the market is based on the position of the home price index ("HPI") for the census division, relative to a long-run trend in the HPI that considers the growth in home prices relative to income. The market assignment for a loan is established at origination, and does not change based on subsequent changes in home prices.[9] The market assignment is a function of the difference between the current HPI and a conservative view of the long-run HPI trend.

An alternative approach would be for FHFA to require the GSEs to hold in reserve a portion of all guarantee fees to create a "contingency reserve" that would only be available to pay losses on the guarantee business. Just as it operates for MI companies, the contingency reserve would build during good markets and then would be available when needed to pay losses during downturns. A contingency reserve would also eliminate the need for a going concern buffer, since such a reserve would provide a source of funding for the GSEs to pay losses on guarantees during times of market stress. And, unlike a going concern buffer, the contingency reserve would not be additive to capital requirements (and thus would not put pressure on GSE pricing).

The contingency reserve was an important source of capital retained by the MIs in good times to support the payment of claims during the financial crisis. Figure 3 below shows the way Genworth's contingency reserve grew in the years leading up to the crisis. As losses headed toward their peak, Genworth drew down the contingency reserve to pay claims. As the housing market recovered, we began to rebuild the contingency reserve.

<u>Figure 3.</u>



Bank Capital versus Insurance Capital.

The Rule is based on a framework that, according to FHFA, is "generally consistent" with the regulatory regime for large banks under the Basel framework as adopted in the United States, modified to reflect features of the GSEs that differ significantly from banks. Basel applies to depository institutions that, among other things, are subject to a possible "run on the bank" that would curtail new revenue. As a result, bank capital requirements focus on equity capital to meet prescribed ratios, while most insurance frameworks are primarily focused on ensuring liquid (available) assets are sufficient to pay claims under stress. While the banking approach may make sense for a bank capital standard that is intended as a point-in-time evaluation of capital adequacy, it is less suited to the guarantee business of the GSEs, where there is a defined, contractual revenue stream available to the GSEs on business they have written, and where the GSEs would have no obligation to pay losses unless the underlying contractual terms for their guarantee have been satisfied.

In the case of the GSEs' core guarantee business, their business model is much closer to that of insurance companies than deposit-taking banks. This is true even for banks that may have an unusually high concentration in mortgage assets because banks typically hold mortgages as whole loans, thereby exposing their institutions to interest rate and market risk in addition to credit risk. For the GSEs, on the other hand, virtually all the risk they bear from their guarantee business is credit risk.[10] Given these differences, Genworth suggests that FHFA consider using an insurance framework, that would more closely align with the guarantee business of the GSEs, as a starting point for the Rule. This approach could minimize some of the complexity of the Rule, much of which results from the need to modify the bank framework to better reflect the actual business of the GSEs.

The Rule varies from the Basel framework in the risk weights assigned to mortgage assets. The Basel standardized approach assesses a 50 percent risk weight for prudently underwritten mortgages, without any adjustments based on risk characteristics of the loans held in portfolio.[11] Genworth agrees that a more nuanced approach to risk weights is appropriate for monolines that engage in secondary market activities for the residential mortgage market (versus banks that are engaged in a range of business activities related to multiple asset classes). However, as discussed above, relying on look-up tables without providing access to the data, assumptions or models used to create the tables makes it difficult for any commenter to evaluate the multipliers and haircuts in the look-up tables. As also discussed above, Genworth is concerned that the application of multiple multipliers to loans with stacked risk factors may result in too much capital being assigned to those loans.

[10] The GSEs do hold some loans in portfolio, but their portfolios continue to shrink, and their exposure to interest rate risk and market risk for their portfolios is dwarfed by the credit risk they assume through their respective guarantee businesses.

[11] There are two approaches to bank capital in the U.S.: the standardized approach that applies to all banks (under which mortgages have a 50 percent risk weight regardless of risk attributes), and the internal ratings-based approach; that applies only to the largest banks. However, under the "Collins Amendment" to the Dodd Frank Act, the largest banks must hold capital at the greater of the amount calculated under the standardized approach or the internal ratings-based approach. Generally, the standardized approach results in higher ratios, and thus governs.

Given the potential for differences in capital regimes to encourage "regulatory arbitrage" regarding investments in mortgages or mortgage credit risk, we urge FHFA to work with bank and insurance regulators to assess the Rule not only as a stand-alone capital regime, but also as one of several capital regimes that apply to mortgage credit risk. We are not suggesting that there needs to be a single capital standard; rather, we simply are calling for a thoughtful review to ensure that differences are grounded in sound analytics or articulated policy justifications.

Guarantee Fee Revenue on Existing Guarantee Business.

The Rule fails to give any capital credit for future guarantee fees on existing business, even though those revenue streams represent a clear contractual obligation. FHFA considered inclusion of revenue to "reflect the fact that the Enterprises would be conducting new business and that the majority of borrowers would continue to pay their mortgage even during a stressful macroeconomic event." FHFA opines that there is "greater benefit" to excluding revenue, presumably under the logic that more capital is always better than less. Genworth respectfully disagrees because too much capital can lead to imprudent risk decisions to generate satisfactory returns, can drive up pricing (and in turn, stifle the health of the housing market), can undermine investor confidence if a GSE is deemed undercapitalized simply because the "bar" for capital is set too high, and can create barriers to entry for competition.

FHFA followed the Basel framework when determining not to give capital credit for future revenues on existing business. While this approach may make sense for a bank capital standard that is intended as a point-in-time evaluation of capital adequacy, it is less suited to the guarantee business of the GSEs, where there is a defined, contractual revenue stream available to the GSEs on business they have written, and where the GSEs would have no obligation to pay losses unless the underlying contractual terms for their guarantee have been satisfied.

A better approach that more closely aligns with the GSE guarantee business would be more of a sources-and-uses methodology consistent with the methodology employed by ratings agencies to evaluate insurance companies.[12] The fundamental purpose of a capital framework for the GSEs should be to ensure that they can meet their obligations for the timely payment of principal and interest on mortgages they guarantee, even under stress.[13] As several commenters have already

[12] For example, Standard & Poor's rating methodology for insurance companies includes a capital and earnings assessment that measures an insurer's "ability to absorb losses by assessing capital adequacy prospectively, using quantitative and capital measures. Capital adequacy compares currently available capital resources with capital requirements … ***and then assesses the insurer's ability and willingness to build capital through net retained earnings and thereby fund growth***. *See* Standard & Poor's Ratings Services, *Insurers Rating Methodology* (May 7, 2013).

[13] The role of the GSEs during housing downturns is largely a question of housing policy. Some have argued that the FHA is better suited to step into the market during times of severe stress and high risk. Others have opined that the best response to an overheated market is for lending to tighten. Regardless, if FHFA deems this to be a goal of the Rule, then it is best addressed through a going concern buffer that could complement a sources and uses methodology.

noted,[14] revenue on existing business provides meaningful protection against losses.[15] Recognizing future revenue is also consistent with the methodology for setting Fannie Mae and Freddie Mac guarantee fees. According to FHFA, the GSE guarantee fee is comprised of: expected losses, unexpected/catastrophic losses under severe stress, general and administrative expenses, the 10 basis points collected by Treasury pursuant to the Temporary Payroll Tax Cut Continuation Act of 2011 and a targeted rate of return.[16] To be consistent, at a minimum, that portion of the guarantee fee allocated to unexpected loss and targeted returns should be included in the calculation of capital.[17]

Genworth recommends that FHFA revise the Rule to recognize guarantee fee revenue on existing books of business. Similarly, guarantee fee revenues should be subtracted from capital to the extent such revenues are used to purchase CRT.

Excess Capital for Loans with Stacked Risk Factors.

As experts in mortgage credit risk, Genworth agrees with FHFA that a "one size fits all" approach to risk-based capital is not ideal for mortgage credit risk given decades of performance data that demonstrate that a borrower's credit profile and a mortgage loan's features directly correlate to the performance of a given loan. Characteristics such as the LTV ratio, borrower credit score, debt-to-income ratio and product type should be considered when calculating loan level risk-based capital. However, we are concerned that the cumulative effect of all the multipliers may be more capital than is necessary or appropriate. FHFA acknowledges this problem, which arises in part because "risk factors for which multipliers would be applied [would not be] independent."[18] FHFA's solution of capping multipliers at 3.0 does not appear to solve for the risk of overcapitalizing certain loans, since the cap only applies to loans with LTVs (original or mark-to-market) above 95 percent.[19]

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[14] Andrew Davidson & Co., Inc. comment letter on Federal Housing Finance Agency Proposed Rule on Enterprise Capital Requirements, July 9, 2018.

[15] As an example of the capital afforded by future revenues on existing business, of the $8.7 billion of claims paid by Genworth since 2008, $6.5 billion of capital used to pay those claims was provided by premiums paid. $3.8 billion of those premiums paid were generated by business insured as of 2008.

[16] *See* Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2016, available at https://www.fhfa.gov/AboutUs/Reports/Pages/Fannie-Mae-and-Freddie-Mac-Single-Family-Guarantee-Fees-in-2016.aspx.

[17] The Rule calculates capital requirements based on "unexpected losses" rather than on total losses under stress (which represent the aggregate of expected and unexpected losses). This approach could result in capital being overstated (to the extent a GSE erroneously attributes more losses to unexpected losses) or understated (to the extent a GSE attributes more losses to expected losses). Getting the allocation wrong could also have significant impact on GSE pricing, which in turn could materially impact the residential housing market. A GSE that wanted to increase pricing could simply reallocated losses to unexpected or vice versa. Genworth recommends that capital be assessed based on the sum of expected plus unexpected losses to avoid potentially over-or under-stating capital requirements.

[18] 83 Fed. Reg. at 33349.

[19] We note that the narrative portion of the Rule states that the three percent cap would apply to loans with mark-to-market LTVs greater than 95 percent, but language in Subchapter C states that the cap applies based on original LTV or mark-to-market. 83 Fed. Reg. 33407.

Credit Risk Transfer.

Beginning in 2013, the GSEs began engaging in CRT transactions that are designed to transfer risk from Fannie Mae and Freddie Mac to third party entities or to the capital markets.[20] As noted by FHFA, the GSEs retain the first 50 basis points of loss in most of their CRT transactions because it is not economically sensible to purchase credit protection for that first loss position.[21] This is an important distinction between the CRT programs and traditional private mortgage insurance, which does assume a first loss position with pricing that is subject to regulatory scrutiny. As a matter of policy, the Rule should assess capital in a way that encourages the transfer of first loss. Otherwise, the laudable goal of "de-risking" the GSEs is undermined.

It appears that the Rule does not recognize the cost to the GSEs of purchasing credit risk protection via CRT. The Rule uses a five-step process to calculate capital relief from a CRT transaction. *First*, capital is allocated to individual tranches. *Second*, capital relief is calculated accounting for tranche ownership. *Third and fourth*, capital relief is adjusted to account for loss timing and counterparty credit risk. *Finally*, total capital relief is calculated by adding capital relief for each tranche and reducing capital relief by any counterparty credit risk capital. Genworth recommends that these calculations be revised to account for the amount paid by the GSE to investors in the CRT. This revision would better align capital relief with the actual value to each GSE.

Lastly, Genworth believes that the Rule should evaluate each CRT transaction under severe stress to ensure that GSE capital requirements takes into consideration losses that the GSEs would incur above the risk transferred via the CRT transaction (residual risk retained). In this regard, we urge FHFA to make public the methodology it uses to develop loss curves for each CRT transaction. More transparency would permit us, and other commenters, to provide constructive feedback on whether the Rule appropriately assigns capital to CRT transactions.

Minimum Leverage Capital and Going Concern Buffer.

The Rule is comprised of two primary components: risk-based capital and minimum leverage capital (a percentage of total assets and off-balance sheet guarantees). In addition, FHFA is suggesting a going-concern buffer that would be risk invariant. The minimum leverage requirement is intended to serve as a backstop to guard against the possibility that risk-based capital requirements underestimate risk. FHFA rightfully acknowledges that a binding leverage requirement could incent the GSEs to hold riskier assets on balance sheet, and possibly to engage in fewer CRT transactions. Genworth questions the need for both a going concern buffer *and* a minimum leverage requirement. In the event FHFA retains the leverage requirement, Genworth suggests that one approach would be to adopt a formula analogous to the risk-to-capital ratio that state insurance regulators currently apply to

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[20] *See, e.g.*, FHFA 2017 Scorecard Progress Report, available at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2017-Scorecard-Progress-Report.pdfe.
[21] *See, e.g.*, Prepared Remarks of Melvin L. Watt, Director of FHFA, at American Mortgage Conference, available at https://www.fhfa.gov/Media/PublicAffairs/Pages/Prepared-Remarks-of-Melvin-L-Watt-Director-of-FHFA-at-American-Mortgage-Conference-North-Carolina-Bankers-Association.aspx.

mortgage insurers. A risk invariant risk to capital ratio would serve as a "check" on the amount of capital stacked against the GSEs' guarantee businesses without encouraging undue risk.[22]

Policy Implications of the Rule.

The GSEs play a foundational role in the U.S. housing market. A capital framework that is punitive will unnecessarily drive up the cost of homeownership. This outcome would be especially challenging for first time homebuyers and borrowers with modest incomes. On the other hand, a framework that fails to calculate sufficient capital could encourage excessive risk taking and could undermine the stability and resilience of the housing market. Layering of multipliers, failure to recognize revenue, procyclicality and the potential to penalize credit enhancers based on subjective, opaque justifications could all result in capital requirements that miss the regulatory mark. We urge FHFA to share any assessment you have performed of the impact of the Rule in light of these significant policy implications.[23]

FHFA Should Treat the Rule as an ANPR.

Genworth commends FHFA for attempting to introduce a new regulatory capital framework for the GSEs. However, for the reasons set forth above, Genworth urges FHFA to treat the Rule as an ANPR and publish a NPR that reflects comments received and that includes all underlying data, models, and assumptions. This process will provide much-needed transparency, and it permits us to provide your Agency with the robust and detailed commentary that a new capital framework needs and deserves.

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Questions

Question 1: FHFA is soliciting comments on all aspects of the proposed risk-based capital framework. What modifications to the proposed risk-based capital framework should be considered and why?

As discussed in more detail above and in subsequent responses below, Genworth recommends the following modifications to the Rule:

1. **Transparency.** The Rule lacks transparency in many material aspects, which makes it difficult for Genworth to provide the robust and analytical feedback that a rule of this

[22] Consistent with our comments regarding future guarantee fee revenue in "The Rule Should Recognize Guarantee Fee Revenue on Existing Guarantee Business," State insurance regulators do include MI premiums in the calculation of capital for purposes of the risk to capital ratio.

[23] To be clear, Genworth is not suggesting that a granular approach to risk-based capital is not a prudent approach for a prudential regulator to adopt. For those policymakers that believe that the GSEs should cross subsidize pricing, it is important to recognize that a granular capital approach does not prevent cross-subsidized pricing. If Congress and the Administration decide that U.S. housing policy should imbed a degree of cross-subsidization, the best way to affect that is to start with a robust and granular assessment of risk-based capital. Without that, it will be very difficult, if not impossible, to make informed decisions about pricing and cross-subsidization.

consequence deserves. Genworth urges FHFA to release all data, assumptions, and models that it used to develop the Rule, including the existing CCF, so that we may provide FHFA with the analytical assessment that this undertaking merits.

2. **Regulated Entity Discretion.** FHFA grants significant discretion to each GSE, especially in counterparty ratings and credit for mortgage insurance. Decision-making pursuant to the Rule should be based on publicly available objective criteria. For this reason, Genworth recommends that FHFA delete Table 20 (Counterparty Financial Strength Ratings) and instead use PMIERs as a tool to hold counterparties to the same set of transparent standards.
3. **Procyclicality.** The Rule is procyclical, which could permit the GSEs to release capital as housing markets are peaking and could require the GSEs to attempt to raise new capital during downturns when investors may be scarce and the cost of capital high. Genworth recommends that FHFA implement a methodology to make the Rule operate in a countercyclical fashion.
4. **Bank vs. Insurance Models.** The Rule appears to be based on the Basel III capital standards for banking institutions. An insurance-oriented capital model would be a better starting point in light of the core guarantee business of the GSEs. (See "Bank Capital versus Insurance Capital" above for a further discussion of this issue.)
5. **Recognition of Guarantee Fee Revenue.** Given the similarity of the GSEs' guarantee business to an insurance business model, the Rule should be revised to recognize guarantee fee revenue on existing guarantee business.
6. **Process.** FHFA should treat the Rule as an Advanced Notice of Proposed Rulemaking ("ANPR") and issue a subsequent NPR that reflects comments received, and that includes all data, assumptions, and modeling used to develop the Rule. This will permit Genworth, and other commenters, to provide FHFA with the robust analytical analysis that the Rule merits.

<u>Counterparty Ratings.</u> The Rule grants each GSE significant discretion over the ratings it assigns to counterparties. The Rule requires each GSE to assign a "haircut multiplier" to counterparties that provide credit enhancement. The haircut multiplier depends on a "number of factors" that reflect counterparty risk.[24] Per the Rule, the two main factors driving the multiplier are creditworthiness and mortgage concentration. Financial strength ratings are determined on a one-to-eight scale, and mortgage risk correlation is either "not high" or "high," based on each GSE's view on the counterparty's concentration in mortgage credit risk. Beyond this broad guidance, the Rule fails to provide objective criteria to determine a counterparty's rating. Moreover, the Rule does not require the GSEs to be consistent in how they develop and apply the haircut multiplier, nor does it ensure that FHFA will examine the GSEs' use of factors. This is concerning for several reasons. This lack of transparency could allow the GSEs to assign counterparty ratings to an entity simply to ensure the GSE receives optimum capital credit for a given credit enhancement (or conversely, assign a counterparty a lower rating to justify a business decision to refuse to do business with a counterparty). The Enterprises engage in the same line of business, in the same markets, and during the same cycles, so it is difficult to understand why they should each employ different subjective assessments of risk features such as counterparty strength or mortgage concentration. Leaving counterparties to speculate

[24] 83 Fed. Reg. at 33354.

how to price and capitalize their business to drive higher ratings could have a direct impact on the cost of mortgage credit, and we urge FHFA to reconsider this approach.

Fortunately, there is a readily-available solution to replace the Rule's approach to counterparty ratings: FHFA, in conjunction with the Enterprises, has designed a robust tool for overseeing and evaluating counterparties through PMIERs. PMIERs set capital and liquidity standards for private mortgage insurers, and they provide a framework for operational oversight. Genworth recommends evaluation of all GSE counterparties under PMIERs, which are objective, transparent, and consistently applied by both GSEs. Entities that are PMIERs-compliant would not be subject to any haircut, simply because PMIERs are designed to provide assurance that a counterparty will have the resources and operational strength to meet its claims paying obligations. While the simplest approach would be to require all counterparties to meet the PMIERs standards (recognizing that some modifications may be needed to adapt PMIERs to different business lines), an alternative approach would be to permit the GSEs to engage in some (limited) credit risk transfer with entities that do not satisfy PMIERs, but those entities would be subject to a counterparty haircut.

<u>Mortgage Concentration.</u> As stated in the NPR, the relative risk of banks compared to the Enterprises differ in important ways, including: sources and risk levels of income and assets, differences in funding risk, and the relative exposure to mortgage assets.[25] FHFA notes that the risk assumed by the GSEs related to mortgages is overall less than the risk assumed by banks, because banks invest in whole loans, which expose them to interest rate, market *and* credit risk, while the GSEs are not exposed to interest and market risk in their core guarantee business. The same is true for private mortgage insurers ("MIs"), which also are exposed primarily to credit risk, and which are experts in assessing mortgage credit risk across cycles.[26] As part of their expertise, private MIs have the capacity to perform an independent credit underwrite on mortgages they insure, which provides added risk protections to the GSEs. As such, the monoline business of counterparties such as private MIs should be considered a positive. Applying a haircut because an MI has a "high" correlation to mortgage assets is punitive and unnecessary, especially in light of the high standards imposed by PMIERs. Moreover, the monoline business model of private MIs give them strong commercial incentives to remain in the market across cycles, because new business insured after a market correction generates premium to rebuild capital that was deployed for its intended purpose of absorbing the shock of a market stress event. The Rule should encourage, not discourage, the use of counterparties with expertise in assessing mortgage credit risk. In addition, the Rule should be grounded in clear, objective and consistent standards applied equally by both GSEs to provide clarity and certainty to counterparties, and to ensure that the GSEs are adequately, but not excessively, capitalized.

<u>Credit for Mortgage Insurance.</u> Genworth's analysis suggests that the Rule significantly understates the benefit of loan level mortgage insurance. As illustrated in Figure 1 below, Genworth evaluated the CE Multipliers using a sample set of performing loans with non-cancellable MI that are insured by the Company to "back test" the CE multipliers that would be used to reduce the gross credit risk capital

[25] 83 Fed. Reg. at 33323.

[26] Today, private MI insures against a portion of the credit risk, pursuant to contractually defined terms. Among other things, this has the effect of ensuring that mortgage servicers have "skin in the game" if remote losses exceed the amount of MI coverage.

requirements for loans that benefit from loan level credit enhancement.[27] The sample set consisted of loans originated in 2006 and 2007 to evaluate loan performance during a stress period. Our analysis indicates the CE multipliers in the Rule do not recognize the full benefit of loan level credit enhancement. For example, a loan with an original LTV of 90 percent and standard, non-cancellable MI coverage would have a multiplier of 41 percent, meaning that the capital requirement for that loan would be reduced by 59 percent due to the MI coverage. However, our analysis suggests that the capital requirement could be reduced by 70 to 80 percent. This analysis suggests that the GSEs are being required to hold almost twice as much more capital as is needed. Overstating CE multipliers could result in over-priced guarantee fees for low down payment loans. Such an outcome could increase the cost of homeownership, which would be especially challenging for first time homebuyers and lower-wealth borrowers.

Figure 1.

LTV / MI Coverage	CE Multiplier	Genworth Back Test
91-95 LTV 30% Coverage	31%	20-30%
86-90 LTV 25% Coverage	41%	20-30%
80-85 LTV 12% Coverage	71%	40%

[27] 83 Fed. Reg. at 33348-49.

Recognition of Guarantee Fee Revenue. The Rule fails to give any capital credit for future guarantee fees on existing business, even though those revenue streams represent a clear contractual obligation. FHFA considered inclusion of revenue to "reflect the fact that the Enterprises would be conducting new business and that the majority of borrowers would continue to pay their mortgage even during a stressful macroeconomic event." FHFA opines that there is "greater benefit" to excluding revenue, presumably under the logic that more capital is always better than less. Genworth respectfully disagrees, because too much capital can lead to imprudent risk decisions to generate satisfactory returns, can drive up pricing (and in turn, stifle the health of the housing market), can undermine investor confidence if a GSE is deemed undercapitalized simply because the "bar" for capital is set too high, and can create barriers to entry for competition.

FHFA followed the Basel framework when determining not to give capital credit for future revenues on existing business. While this approach may make sense for a bank capital standard that is intended as a point-in-time evaluation of capital adequacy, it is less suited to the guarantee business of the GSEs, where there is a defined, contractual revenue stream available to the GSEs on business they have written, and where the GSEs would have no obligation to pay losses unless the underlying contractual terms for their guarantee have been satisfied.

A better approach that more closely aligns with the GSE guarantee business would be more of a sources-and-uses methodology consistent with the methodology employed by ratings agencies to evaluate insurance companies.[28] The fundamental purpose of a capital framework for the GSEs should be to ensure that they can meet their obligations for the timely payment of principal and interest on mortgages they guarantee, even under stress.[29] As several commenters have already noted,[30] revenue on existing business provides meaningful protection against losses.[31] Recognizing future revenue is also consistent with the methodology for setting Fannie Mae and Freddie Mac guarantee fees. According to FHFA, the GSE guarantee fee is comprised of: expected losses, unexpected/catastrophic losses under severe stress, general and administrative expenses, the 10 basis points collected by Treasury pursuant to the Temporary Payroll Tax Cut Continuation Act of 2011 and

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[28] For example, Standard & Poor's rating methodology for insurance companies includes a capital and earnings assessment that measures an insurer's "ability to absorb losses by assessing capital adequacy prospectively, using quantitative and capital measures. Capital adequacy compares currently available capital resources with capital requirements … ***and then assesses the insurer's ability and willingness to build capital through net retained earnings and thereby fund growth***. *See* Standard & Poor's Ratings Services, *Insurers Rating Methodology* (May 7, 2013).

[29] The role of the GSEs during housing downturns is largely a question of housing policy. Some have argued that the FHA is better suited to step into the market during times of severe stress and high risk. Others have opined that the best response to an overheated market is for lending to tighten. Regardless, if FHFA deems this to be a goal of the Rule, then it is best addressed through a going concern buffer that could complement a sources and uses methodology.

[30] Andrew Davidson & Co., Inc. comment letter on Federal Housing Finance Agency Proposed Rule on Enterprise Capital Requirements, July 9, 2018.

[31] As an example of the capital afforded by future revenues on existing business, of the $8.7 billion of claims paid by Genworth since 2008, $6.5 billion of capital used to pay those claims was provided by premiums paid. $3.8 billion of those premiums paid were generated by business insured as of 2008.

a targeted rate of return.[32] To be consistent, at a minimum, that portion of the guarantee fee allocated to unexpected loss and targeted returns should be included in the calculation of capital.[33]

Genworth recommends that FHFA revise the Rule to recognize guarantee fee revenue on existing books of business. Similarly, guarantee fee revenues should be subtracted from capital to the extent such revenues are used to purchase CRT.

Policy Implications of the Rule. The GSEs play a foundational role in the U.S. housing market. A capital framework that is punitive will unnecessarily drive up the cost of homeownership. This outcome would be especially challenging for first time homebuyers and borrowers with modest incomes. On the other hand, a framework that fails to calculate sufficient capital could encourage excessive risk taking and could undermine the stability and resilience of the housing market. Layering of multipliers, failure to recognize revenue, procyclicality, and the potential to penalize credit enhancers based on subjective, opaque justifications could all result in capital requirements that miss the regulatory mark. We urge FHFA to share any assessment you have performed of the impact of the Rule in light of these significant policy implications.[34]

FHFA Should Treat the Rule as an ANPR. Genworth commends FHFA for attempting to introduce a new regulatory capital framework for the GSEs. However, for the reasons set forth above, Genworth urges FHFA to treat the Rule as an ANPR and publish a NPR that reflects comments received and that includes all underlying data, models, and assumptions. This process will provide much-needed transparency, and it permits us to provide your Agency with the robust and detailed commentary that a new capital framework needs and deserves.

Question 3: FHFA is soliciting comments on the use of updated risk characteristics, including LTV and credit score, in the proposed risk-based capital requirements, particularly as it relates to the pros and cons of having risk-based capital requirements with elements of pro-cyclicality.

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[32] *See* Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2016, available at https://www.fhfa.gov/AboutUs/Reports/Pages/Fannie-Mae-and-Freddie-Mac-Single-Family-Guarantee-Fees-in-2016.aspx.

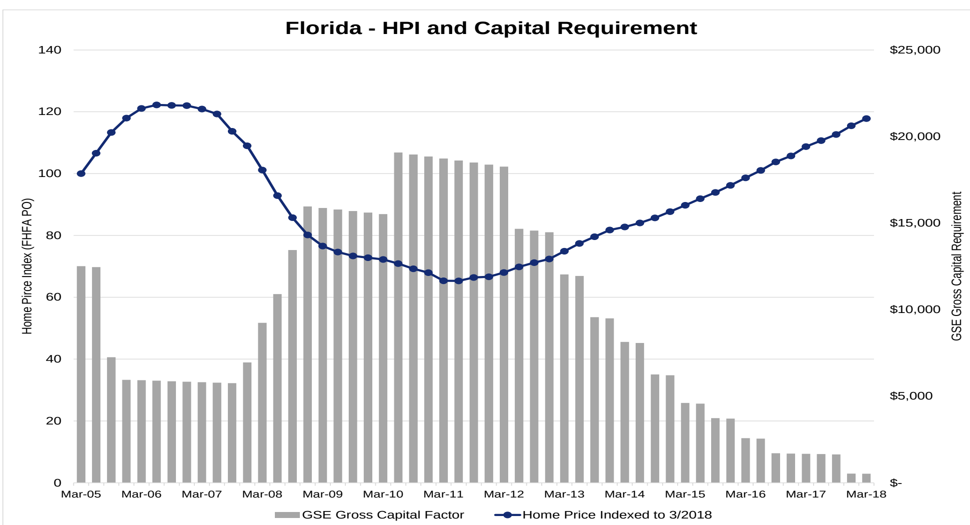
[33] The Rule calculates capital requirements based on "unexpected losses" rather than on total losses under stress (which represent the aggregate of expected and unexpected losses). This approach could result in capital being overstated (to the extent a GSE erroneously attributes more losses to unexpected losses) or understated (to the extent a GSE attributes more losses to expected losses). Getting the allocation wrong could also have significant impact on GSE pricing, which in turn could materially impact the residential housing market. A GSE that wanted to increase pricing could simply reallocated losses to unexpected or vice versa. Genworth recommends that capital be assessed based on the sum of expected plus unexpected losses to avoid potentially over-or under-stating capital requirements.

[34] To be clear, Genworth is not suggesting that a granular approach to risk-based capital is not a prudent approach for a prudential regulator to adopt. For those policymakers that believe that the GSEs should cross subsidize pricing, it is important to recognize that a granular capital approach does not prevent cross-subsidized pricing. If Congress and the Administration decide that U.S. housing policy should imbed a degree of cross-subsidization, the best way to affect that is to start with a robust and granular assessment of risk-based capital. Without that, it will be very difficult, if not impossible, to make informed decisions about pricing and cross-subsidization.

The Rule uses mark-to-market LTVs and current (refreshed) credit scores to refresh the risk-based capital requirements for mortgages held or guaranteed by the GSEs because FHFA is of the view that both features are "primary drivers of credit losses" for performing seasoned loans.[35] These provisions have the combined effect of making the Rule "procycylical" by potentially permitting capital to be released in good times (when borrower credit scores improve, and home equity grows), and increasing capital when markets are under stress. As FHFA acknowledges, the result could be to exacerbate housing market downturns as the GSEs (and their counterparties) likely will be required to (1) raise capital at very high cost, and/or (2) pull back on guaranteeing new business to husband capital. That in turn will put further downward pressure on a housing market that is already experiencing a downturn and transfer more risk to taxpayers as increased GSE pricing shifts more borrowers market to government-insured programs such as FHA insurance.

To demonstrate the procyclical effect of the Rule, Figure 2 below shows the way risk-based capital would have been assessed had the Rule been in effect for a single loan originated in Florida in early 2005.[36] The capital required would have fallen substantially in 2007 (at the height of the run up to the financial crisis), and then would have increased dramatically in 2008-2009, when losses were hitting and capital was scarce.

<u>Figure 2.</u>



[35] 83 Fed. Reg. at 33336.

[36] Assumes a hypothetical $300,000 30-year, fixed rate mortgage originated in Florida in Q1 2005, interest rate of four percent, LTV 95 percent, and the hypothetical borrower maintains a credit score of 740.

Genworth recommends that FHFA consider a countercyclical methodology that would dampen the procyclical impact of the Rule. One possible approach would be analogous to the approach used in the risk-based capital model being considered by the National Association of Insurance Commissioners ("NAIC"). This model makes the amount of capital held for a loan at origination a function of where house prices are relative to long-run trends.[37] This is achieved through differentiating components of required resources by different "markets." These markets are defined each quarter for each U.S. census division, and reflect four different potential future home price decline paths.[38]

An alternative approach would be for FHFA to require the GSEs to hold in reserve a portion of all guarantee fees to create a "contingency reserve" that would only be available to pay losses on the guarantee business. Just as it operates for MI companies, the contingency reserve would build during good markets, and then would be available when needed to pay losses during downturns. A contingency reserve would also eliminate the need for a going concern buffer, since such a reserve would provide a source of funding for the GSEs to pay losses on guarantees during times of market stress. And, unlike a going concern buffer, the contingency reserve would not be additive to capital requirements (and thus would not put pressure on GSE pricing).

The contingency reserve was an important source of capital retained by the MIs in good times to support the payment of claims during the financial crisis. Figure 3 below shows the way Genworth's contingency reserve grew in the years leading up to the crisis. As losses headed toward their peak, Genworth drew down the contingency reserve to pay claims. As the housing market recovered, we began to rebuild the contingency reserve.

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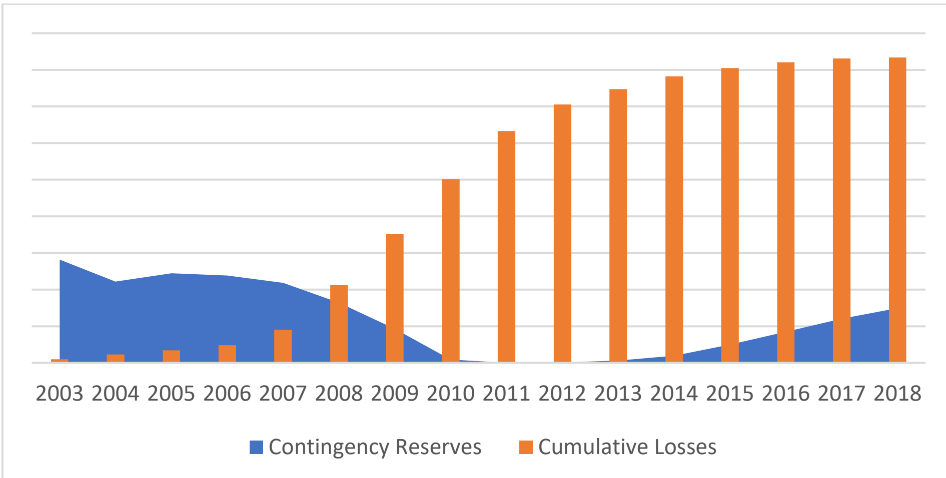
[37] *See* Mortgage Insurance Risk Based Capital: Overview of Proposed RBC Approach (May 9, 2016), available at https://www.naic.org/documents/committees_e_mortgage_guaranty_insurance_wg_expsosure_mirbc_overview_proposed_rbc_approach.pdf?23

[38] The assignment of the market is based on the position of the home price index ("HPI") for the census division, relative to a long-run trend in the HPI that considers the growth in home prices relative to income. The market assignment for a loan is established at origination, and does not change based on subsequent changes in home prices.[38] The market assignment is a function of the difference between the current HPI and a conservative view of the long-run HPI trend.

Figure 3.



Question 5: FHFA is soliciting comments on the proposed going-concern buffer. What modifications to the proposed going-concern buffer should be considered and why?

The Rule is comprised of two primary components: risk-based capital and minimum leverage capital (a percentage of total assets and off-balance sheet guarantees). In addition, FHFA is suggesting a going-concern buffer that would be risk invariant. The minimum leverage requirement is intended to serve as a backstop to guard against the possibility that risk-based capital requirements underestimate risk. FHFA rightfully acknowledges that a binding leverage requirement could incent the GSEs to hold riskier assets on balance sheet, and possibly to engage in fewer CRT transactions. Genworth questions the need for both a going concern buffer *and* a minimum leverage requirement. In the event FHFA retains the leverage requirement, Genworth suggests that one approach would be to adopt a formula analogous to the risk-to-capital ratio that state insurance regulators currently apply to mortgage insurers. A risk invariant risk to capital ratio would serve as a "check" on the amount of capital stacked against the GSEs' guarantee businesses without encouraging undue risk.[39]

Question 6: FHFA is soliciting comments on the proposed framework for calculating credit risk capital requirements for single-family whole loans and guarantees, including the loan segments, base grids, and risk multipliers. What modifications should FHFA consider and why?

In the narrative accompanying the Rule, FHFA cites transparency as a key objective for the Rule. To accomplish this, FHFA has elected to distinguish risk based on a series of grids (sometimes referred to as look-up tables) and multipliers or haircuts, assessments of counterparty risk, and capital relief due to CRT transactions. However, without access to the existing CCF or the data, assumptions, and

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[39] Consistent with our comments regarding future guarantee fee revenue in "The Rule Should Recognize Guarantee Fee Revenue on Existing Guarantee Business," State insurance regulators do include MI premiums in the calculation of capital for purposes of the risk to capital ratio.

models used to develop the look-up tables, it is extremely difficult to assess the appropriateness of the risk weights assigned to mortgages based on their risk characteristics. This opaqueness is compounded by the application of multipliers, such as Counterparty Financial Strength Ratings, that are assigned by each Enterprise based on subjective, discrete GSE assessments that the Rule does not contemplate publishing. Other areas that would benefit from additional transparency include:

- The Rule applies "risk multipliers" (Table 14) to a base credit grid (Tables 9-13) that generally comports with Genworth's view of loan characteristics that can impact losses and capital. However, it is not clear to us the extent to which certain multipliers (for example, "cohort burnout") correlate to loan performance.
- As experts in mortgage credit risk, Genworth agrees with FHFA that a "one size fits all" approach to risk-based capital is not ideal for mortgage credit risk given decades of performance data that demonstrate that a borrower's credit profile and a mortgage loan's features directly correlate to the performance of a given loan. Characteristics such as the LTV ratio, borrower credit score, debt-to-income ratio, and product type should be considered when calculating loan level risk-based capital. However, we are concerned that the cumulative effect of all the multipliers may be more capital than is necessary or appropriate. FHFA acknowledges this problem, which arises in part because "risk factors for which multipliers would be applied [would not be] independent."[40] FHFA's solution of capping multipliers at 3.0 does not appear to solve for the risk of overcapitalizing certain loans, since the cap only applies to loans with LTVs (original or mark-to-market) above 95 percent.[41]
- The Rule was developed using components of risk-based capital rules both for banks and for insurance companies, but we do not know which aspects of which capital regimes FHFA applied, and how FHFA reconciled differences in the approaches.
- FHFA has used historical loan level data to develop the Rule and to "back test" it against the loss experience of each GSE in 2007, only some of which is publicly available. While look-up tables should be easier to understand and implement than a model-based approach, the application of the tables requires a multi-step process that is complicated to administer. In some cases, the application of the multipliers and haircuts results in outcomes that FHFA could not reasonable have intended. For example, the Rule assigns a "CE Multiplier" of zero for loans supported by a full recourse agreement with the seller. Application of the "CP Haircut" will always result in 100 percent capital credit for the recourse, regardless of the financial rating of the seller. This result is contrary to the purpose of the Rule and could encourage lenders to game the system through the use of special purpose vehicles to sell loans.[42]
- The Rule will apply to the GSEs only *after* they exit conservatorship. However, no decisions have been made about the business model of the GSEs on a post-conservatorship basis, and so

[40] 83 Fed. Reg. at 33349.

[41] We note that the narrative portion of the Rule states that the three percent cap would apply to loans with mark-to-market LTVs greater than 95 percent, but language in Subchapter C states that the cap applies based on original LTV or mark-to-market. FHFA and HUD Enterprise Capital Requirements, 83 Fed. Reg. 33407.
[42] We assume that the CP Haircut is a drafting error that FHFA will correct in the next draft of the Rule.

> Genworth suggests that a better course would be defer further work on a post-conservatorship framework until there is some clarity around the ultimate resolution of the GSEs. In the meantime, we recommend that FHFA leverage the work done for the Rule to further refine the existing CCF (which should be made public).

Question 10: Does the proposed rule's approach of providing capital relief for CRTs adequately capture the risk and benefits associated with the Enterprises' CRT transactions? Should FHFA consider modifications or alternatives to the proposed rule's approach of providing capital relief for the Enterprises' CRTs, and if so, what modifications or alternatives, and why?

Beginning in 2013, the GSEs began engaging in CRT transactions that are designed to transfer risk from Fannie Mae and Freddie Mac to third party entities or to the capital markets.[43] As noted by FHFA, the GSEs retain the first 50 basis points of loss in most of their CRT transactions because it is not economically sensible to purchase credit protection for that first loss position.[44] This is an important distinction between the CRT programs and traditional private mortgage insurance, which does assume a first loss position with pricing that is subject to regulatory scrutiny. As a matter of policy, the Rule should assess capital in a way that encourages the transfer of first loss. Otherwise, the laudable goal of "de-risking" the GSEs is undermined.

It appears that the Rule does not recognize the cost to the GSEs of purchasing credit risk protection via CRT. The Rule uses a five-step process to calculate capital relief from a CRT transaction. *First*, capital is allocated to individual tranches. *Second*, capital relief is calculated accounting for tranche ownership. *Third and fourth*, capital relief is adjusted to account for loss timing and counterparty credit risk. *Finally*, total capital relief is calculated by adding capital relief for each tranche and reducing capital relief by any counterparty credit risk capital. Genworth recommends that these calculations be revised to account for the amount paid by the GSE to investors in the CRT. This revision would better align capital relief with the actual value to each GSE.

Lastly, Genworth believes that the Rule should evaluate each CRT transaction under severe stress to ensure that GSE capital requirements take into consideration losses that the GSEs would incur above the risk transferred via the CRT transaction (residual risk retained). In this regard, we urge FHFA to make public the methodology it uses to develop loss curves for each CRT transaction. More transparency would permit us, and other commenters, to provide constructive feedback on whether the Rule appropriately assigns capital to CRT transactions.

Question 28: Should FHFA consider additional capital buffers, such as buffers to address pro-cyclical risks, in addition to the leverage ratio and FHFA's existing authority to temporarily increase Enterprise leverage requirements and why?

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[43] *See, e.g.*, FHFA 2017 Scorecard Progress Report, available at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2017-Scorecard-Progress-Report.pdfe.
[44] *See, e.g.*, Prepared Remarks of Melvin L. Watt, Director of FHFA, at American Mortgage Conference, available at https://www.fhfa.gov/Media/PublicAffairs/Pages/Prepared-Remarks-of-Melvin-L-Watt-Director-of-FHFA-at-American-Mortgage-Conference-North-Carolina-Bankers-Association.aspx.

See Genworth's response to Question 3, above.

Question 39: Commenters are asked to discuss the advantages and disadvantages of adjusting risk-based capital requirements by order during periods of heightened risk.

Genworth understands the importance of regulatory discretion, particularly during times of market stress. However, FHFA and the GSEs would be best served by a framework that operates in a countercyclical fashion. Building in countercyclicality would mitigate the need for FHFA to make "ad hoc" changes to the risk-based capital requirements during downturns, in turn providing more certainty to the GSEs and to the broader housing finance market. See Genworth's response to Question 3, above.

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Genworth appreciates the opportunity to comment on the NPR. Questions or requests for further information may be directed to the undersigned or to Carol Bouchner (Carol.Bouchner@genworth.com).

Very truly yours,

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