November 16, 2018

1750 K STREET, NW
SUITE 300
WASHINGTON, D.C. 20006
Tel. 202.589.1923

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

Re: Enterprise Capital Requirements

Dear Mr. Pollard:

The Housing Policy Council ("HPC")[1] appreciates the opportunity to comment on the Enterprise Capital Requirements (the "proposed capital framework") issued by the Federal Housing Finance Agency ("FHFA").[2] HPC member companies have substantial engagement with Fannie Mae and Freddie Mac (the "Enterprises") as originators and servicers of residential mortgages that are securitized by the Enterprises, as counterparties to the Enterprises in credit risk transfer structures, and as private mortgage insurers. As such, the members of HPC have a direct interest in the impact of the proposed capital framework on the pricing and business decisions of the Enterprises, as well as the manner in which the proposed capital framework contributes to a competitive, equitable, and sound housing finance system.

I. Introduction and Request for Republication

HPC supports the development of a new capital framework for the Enterprises.

HPC supports the development of a new capital framework for the Enterprises. As FHFA has recognized, the existing capital framework is outdated.[3] Adopted in 2001, the current framework is based upon statutory minimum requirements that proved to be insufficient. Any new capital standards must reflect the substantial risks posed by the Enterprises and, in a post-conservatorship environment, foster and promote a competitive, equitable, and sound housing finance system.

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[1] The Housing Policy Council (HPC) is a trade association comprised of 30 of the leading national mortgage lenders, servicers, mortgage insurers, and title and data companies. HPC advocates for the mortgage and housing marketplace interests of its members in legislative, regulatory, and judicial forums. Our interest is in the safety and soundness of the housing finance system, the equitable and consistent regulatory treatment of all market participants, and the promotion of lending practices that create sustainable home ownership opportunities leading to long-term wealth-building and community-building for families.
[2] 83 Fed. Reg. 33312, July, 17, 2018.
[3] 83 Fed. Reg. 33313, Jul7 17, 2018.

While the proposed capital framework will not be implemented as long as the Enterprises remain in conservatorship, it is relevant for today's market since it will be used to assess guarantee fees charged by the Enterprises and to measure returns on imputed capital. The proposed capital framework also is relevant to the future state of the Enterprises since it assumes that, in a post-conservatorship environment, the Enterprises would continue to be systemically important financial institutions, as they clearly are today.

FHFA should republish the proposed capital framework.

HPC urges FHFA to reconsider and rework several features of the proposed capital framework and to republish the proposal with the full set of models, data, and assumptions, embedded in the proposed capital framework. As published, the framework is based upon an existing Conservatorship Capital Framework ("CCF") that has never been disclosed, and it includes a set of models, data, and assumptions that FHFA has not revealed in the proposal. The omission of this critical information precludes HPC members and other interested parties from providing informed comment on key aspects of the proposed capital framework, prevents FHFA from receiving valuable insights and input, and inhibits HPC and other interested parties from understanding and validating significant provisions of the framework.[4]

Republication of the proposed capital framework would give HPC member companies and other interested parties the opportunity to evaluate the proposal in the context of the models, data, and assumptions underlying the proposed capital framework; an approach that is consistent with the principles of the Administrative Procedures Act, which requires "sufficient factual detail and rationale for interested parties to comment meaningfully."[5] Republication of the proposed capital framework also would enable FHFA to deliberate and revisit certain issues that are not sufficiently addressed in the current proposal, including the systemic risk posed by the Enterprises and the pro-cyclical impact of the proposed capital framework.

II. Summary of Key Recommendations

We have four key recommendations for improving the proposed capital framework.

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[4] *The Need for an Additional Notice and Comment Period When Final Rules Differ Substantially from Interim Rules*, Duke Law Journal, Vol: 1981:377 at 382.

[5] Florida Power & Light Company v. United States of America and Nuclear Regulatory Commission 846 F.2d 765 (D.C. Cir. 1988), cert. den. 490 U.S. 1045 (1989). Citing Connecticut Light & Power Co. v. NRC, 673 F.2d 525, 530-31 (D.C. Cir.), cert. denied, 459 U.S. 835, 103 S. Ct. 79, 74 L. Ed. 2d 76 (1982); and Home Box Office, Inc. v. FCC, 567 F.2d 9, 35 (D.C. Cir.), cert. denied, 434 U.S. 829, 98 S. Ct. 111, 54 L. Ed. 2d 89 (1977).

While we support the development of a new capital framework for the Enterprises, that framework should reflect the risks posed by the Enterprises, and, as noted above, it should ensure that, in a post-conservatorship environment, the capital requirements for the Enterprises promote a competitive, equitable, and sound housing finance system. Our key recommendations for achieving these goals are as follows:

- Transparency — FHFA should release details on the existing CCF upon which the proposed capital framework is based, as well as the models, data, and assumptions incorporated in the proposed capital framework, and should invite public comment on a revised proposal so interested parties have sufficient information upon which to perform independent analysis and validation of the proposed capital framework;

- Systemic Risk — FHFA should address the systemic risk posed by the wide array of functions the Enterprises perform, including those that compete directly with private capital, and the control they exercise over housing finance market participants;

- Counter-Cyclical Buffer — FHFA should incorporate a counter-cyclical buffer in the proposed capital framework; and

- Comparability — FHFA should engage other regulators at the federal and state level to ensure that the risk-based capital charge for mortgage credit risk and for other risks, including systemic risk, is comparable across the Enterprises, banks, insurers, and nonbanks.

These key recommendations, and other proposed modifications to the proposed capital framework, are discussed in greater detail in the balance of this letter. Additionally, in Attachment A, we have listed several of the questions posed by FHFA and identified where those questions are addressed in this letter.

III. Transparency

FHFA should release details on the current CCF, as well as the models, data, and assumptions underlying the proposed capital framework, and should invite public comment on that information.

The proposed capital framework is intended to "transparently" communicate FHFA's views as a financial regulator about capital adequacy for the Enterprises under current statutory language and authorities.[6] However, the proposed capital framework is based on the existing CCF that FHFA has never released to the public. Moreover, key features of the proposed capital framework are based upon models, data, and assumptions that FHFA has not disclosed. These include: (1) the models, data, and assumptions supporting the base credit risk capital charges in the risk grids; (2) the

[6] 83 Fed. Reg. 33313, July 17, 2018.

macroeconomic assumptions incorporated in the stress tests used by FHFA to project stressed losses; and (3) the methodology used to set counterparty ratings.

The starting point for the risk-based credit charges in the proposed capital framework is a set of risk grids, or so-called look-up tables that set the base capital charge for a particular mortgage loan or security. We appreciate that FHFA has proposed the use of these tables in order to increase transparency and reduce complexity.[7] However, HPC members cannot reproduce the results in the risk grids. HPC members find that their own internal models produce results that are directionally similar to the results in the grids,but are not the same. We recommend that FHFA disclose the models, data, and assumptions used to produce the tables and invite comment on them. This would permit HPC members and other interested parties the ability to evaluate the values presented in the tables and potentially suggest adjustments to the tables, so they are appropriately aligned with historical mortgage credit risk experience.

We also recommend that FHFA disclose the macroeconomic assumptions incorporated in the stress tests used by FHFA to project credit losses. These assumptions should be comparable to those used by prudential regulators in evaluating capital adequacy through the Comprehensive Capital Analysis and Review ("CCAR"). The disclosure of this information will enable market participants to better evaluate the merits of the proposed rule, and public input will enable FHFA to either affirm or refine the proposed capital framework.

Additionally, in order for market participants to understand the models, data, and assumptions embedded in the proposed capital framework, FHFA should release performance data on *all* loans acquired by the Enterprises since 1999. Both Enterprises currently release loan-level credit performance data. However, that data covers only a portion of the loans that they have acquired. For example, Fannie Mae explains that the loan-level data it releases does not include several loan types that may be riskier than standard 30-year, fixed-rate mortgages, including adjustable-rate mortgage loans, interest-only mortgage loans, mortgage loans with prepayment penalties, and various non-standard mortgage loans.[8] The public release of all loan-level data would enable market participants to evaluate the credit risk captured in the risk grids and other aspects of the proposed capital framework. Moreover, it would assist private capital returning to the market to support mortgage credit risk, thereby reducing taxpayer risk.

IV. Systemic Risk

The Enterprises pose systemic risk to the housing finance system and the economy as a whole.

In 2008, the Enterprises were placed into conservatorship because they were

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[7] 83 Fed. Reg. 33331, July 17, 2018.

[8] Fannie Mae Single-Family Loan Performance Data Frequently Asked Questions (FAQs) https://loanperformancedata.fanniemae.com/lppub-docs/FNMA_SF_Loan_Performance_FAQs.pdf.

deemed to be "so large and so interwoven in our financial system that a failure of either of them would cause great turmoil in our financial markets here at home and around the globe."[9] This systemic risk was the result of the entanglement of the Enterprises in all aspects of primary and secondary mortgage activity.

The conservatorships have not changed this dynamic. In fact, the level of systemic risk posed by the Enterprises is greater today than it was at the start of the conservatorship because of the overall growth in their size, the scope of their activities, and their role as quasi-regulators of other participants in the housing finance market. In recent years, the Enterprises have expanded their direct competition with private market participants in areas outside the direct securitization and guarantee of mortgages. The Enterprises' control of data also is a barrier to private capital, giving them competitive advantages over other private market participants.

The financial risk assumed by the Enterprises is a source of systemic risk and that risk has increased since the start of the conservatorship.

Currently, the Enterprises guarantee $5 trillion in mortgage-backed securities. This is the second largest credit market, after Treasury securities. It represents over half of the U.S. mortgage market. Moreover, the volume of mortgage-backed securities guaranteed by the Enterprises has increased by approximately $750 billion during the conservatorship. Any disruption in this market would have a substantial, and negative, impact on the U.S. housing finance system, as well as the national and global economy.

The dominant role of the Enterprises in housing finance is a source of systemic risk and that risk has increased since the start of the conservatorship.

The Enterprises are intricately integrated into all aspects of the market for conventional mortgage loans. The broad array of primary and secondary market activities the Enterprises perform or control includes:

- Accepting or rejecting lenders and/or servicers to produce, supply, and manage loans for the Enterprises;
- Providing tools and technology for lenders to manufacture loans for delivery, tools that also conduct the core evaluation for borrower qualification and property eligibility and value;
- Determining what mortgage products are eligible for securitization;
- Buying and pooling whole loans directly from lenders;
- Arranging for servicing to be released to Enterprise-selected servicers;
- Issuing pools of loans as mortgage-backed securities, while retaining ownership interest in the assets;
- Master servicing of those assets, overseeing the activities of primary market servicers who manage loan performance and remittance of payments and

[9] "Statement by Treasury Secretary Henry Paulson on Treasury and Federal Housing Finance Agency action to protect financial markets and taxpayers," September 7, 2008. https://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx.

execute loss mitigation practices to cure or liquidate nonperforming loans to satisfy outstanding debt;
- Setting rules for credit enhancers, including counterparty strength, operational engagement, and treatment of the loss coverage provided by these entities;
- Developing and controlling key technologies that advance the integration of primary and secondary market functions;
- Placing a guarantee on the mortgage-backed securities; and
- Performing basic bond administration for those securities.

With the exception of one activity on this list - placing the guarantee on the mortgage-backed securities – there are private sector firms that engage in these activities. Yet, by virtue of their size and role as government sponsored entities, the Enterprises dominate these activities. This concentration of activities by just two firms poses a systemic risk to the housing finance system. It stifles competition and innovation since other market providers are effectively shut out of certain activities due to the special privileges and subsidies available only to the Enterprises, which are bolstered by a taxpayer backstop and an ability to borrow at near-Treasury rates. This concentration of activities also results in a concentration of the tools of risk assessment, risk management, underwriting, and operations, which further compounds the systemic risks arising from these two companies. Today, as was the case ten years ago, the failure of one or both of these firms would severely disrupt the entire mortgage market.

Since the inception of the conservatorship, the Enterprises have expanded their engagement into other aspects of the mortgage credit system. This has further constrained competition and increased the systemic concentration risk posed by the Enterprises. As an example, both Enterprises now perform traditional lending activities, such as warehouse lending and financing for mortgage servicing rights and servicing advances. This new business directly competes with private lenders, with the Enterprises operating with the distinct advantage of borrowing at near-Treasury rates.

Additionally, because of their duopoly position in the housing finance market, the Enterprises collect, and then claim a proprietary interest in, a vast amount of mortgage loan data, which gives them a competitive advantage over other market participants. With this data, the Enterprises control where and when to relax their traditional lending standards, and whether to do so through appraisal waivers, alterations to underwriting, or direct reductions in credit costs for some borrowers. This data also enables them to identify market trends and develop new products and technologies in response to those trends. Furthermore, the data they gather from their operations affects their pricing decisions, an area where they otherwise have an advantage over other participants because taxpayer support enables them to issue debt at approximately government pricing levels.

The systemic risk posed by the Enterprises is exacerbated by their role as quasi-regulators of other firms in the housing finance system.

A key aspect of the systemic risk posed by the Enterprises stems from their role

as quasi-regulators over other firms in the housing finance system. It is well-understood that Enterprise standard-setting has benefited the market. However, this quasi-regulatory role gives them a level of control over the housing finance system that contributes to their systemic concentration risk. This gives them a competitive advantage in the marketplace over private sector providers, including firms for which they are quasi-regulators. For example, although mortgage insurers are supervised by state regulators, the Enterprises mandate a set of distinct capital standards and operational rules for mortgage insurers and approve their master policies. The Enterprises also control the structure and distribution of credit risk through credit risk transfers ("CRTs"), including rules of participation and allocation among competing private capital sources.

Under typical commercial counterparty contracts, two private companies negotiate a set of terms and conditions for business practices, pricing, and risk-sharing. The financial and operational capacity of each entity affects and influences those terms. This traditional balance of negotiating power is undercut by the quasi-regulatory role of the Enterprises. Their ability to establish and enforce industry standards permits them to pick and choose how and when to extend their activities and involvement in the housing finance market. This allows the Enterprises to disintermediate entire companies and lines of business, and results in even greater concentration risk.

A good example is the expansion of the aggregation activities of the Enterprises through the use of their cash windows. Since 2011, the Enterprises have displaced the aggregation role traditionally performed by private lenders, both banks and nonbanks.[10] While this shift can be attributed to several factors, including a withdrawal of some large banks from the business, it has increased counterparty risk for the Enterprises. Traditionally, private loan aggregators served as both an independent source of credit analysis and capital. Without these private companies serving as risk management intermediaries, the oversight function must reside within the Enterprises, and sufficient capital must be held to offset inevitable losses associated with that business when housing markets decline. Another example is the Enterprises' resistance to front-end CRT, including deeper mortgage insurance. This has resulted in most CRT deals being controlled by the Enterprises. Another effect of the growing dominance of the Enterprises, including their quasi-regulatory activities, has been to further inhibit the return of a fully private securitization market.

In sum, the quasi-regulatory role of the Enterprises is contributing to the disintermediation of other market participants. As a result, risk management decisions and procedures that would otherwise be performed by a variety of private companies have been absorbed by the Enterprises. Layers of underwriting controls, data integrity checks, counterparty monitoring, loan-level compliance reviews, performance tracking, and other types of risk management oversight that were once performed by various stakeholders are now concentrated within the two companies in a manner that

[10] Recent Trends in the Enterprises' Purchases of Mortgages from Smaller Lenders and Nonbank Mortgage Companies, Office of Inspector General, Federal Housing Finance Agency, July 17, 2014, p. 17.

increases the risk to the housing finance system as a whole.

FHFA should address the systemic risk posed by the current scope of the functions the Enterprises perform and the control they exercise over housing finance.

One of the stated goals of the conservatorship is to mitigate the systemic risk posed by the Enterprises.[11] Yet, the proposed rule does not adequately address systemic risk. FHFA justifies this position because it has the statutory authority to adjust capital requirements "when prudent."[12] FHFA also notes that, since the inception of the conservatorship, the portfolio business has been reduced in size, and the Enterprises have transferred some of the credit risk to private investors through credit risk transfer structures.

These changes, however, have not reduced the systemic risk posed by the Enterprises. As discussed above, the systemic risk posed by the Enterprises has increased during the conservatorship as a result of the expansion of their functions and the level of control they exercise in the market for housing finance. Moreover, while credit risk transfers have moved some of the credit risk previously retained by the Enterprises to private investors, most of the risk that has been transferred is mezzanine risk, not first dollar or equity risk. Moreover, the credit risk transfer structures have increased the reliance of counterparties on the risk management policies and practices of the Enterprises. In other words, the risk of loss has shifted to another party, but not the means to control or contain that risk; the Enterprises are still responsible for playing that role.

The systemic risk posed by the Enterprises could be addressed by incorporating a systemic risk charge in the risk-based capital requirements, much like the federal banking agencies have imposed on the nation's largest banking organizations. Alternatively, the FHFA could evaluate the risk posed by each of the various activities of the Enterprises and establish a capital charge against each of these activities, with added buffers for those that pose the greatest systemic risk.

Another option for FHFA would be to review the current activities of the Enterprises to determine if they are necessary for the housing finance system to operate efficiently and safely, and if there are alternative providers that would reduce the systemic risk posed by the Enterprises. All activities, of course, are expected to be consistent with the Enterprises' statutory mission and charters. Such a review may suggest the need for limitations on the activities of the Enterprises during the remainder of the conservatorship. Appropriately structured, such limitations could reduce the concentrated control the Enterprises currently exercise in housing finance and the systemic risk associated with that control.

In summary, the systemic risk posed by the Enterprises may be addressed in two ways, either through the addition of a systemic risk charge (or charges) or through

[11] 83 Fed. Reg. 33318, July 17, 2018.
[12] 83 Fed. Reg. 33324, July 17, 2018.

changes in the scope of the operations and activities of the Enterprises. This is precisely the choice that the Federal Reserve Board gave to the nation's largest banking organizations when it imposed the so-called G-SIB surcharge. As Federal Reserve Board Chair Yellen noted when the G-SIB surcharge was adopted for large banking organizations "…this final rule will confront these firms with a choice: they must either hold substantially more capital, reducing the likelihood that they will fail, or else they must shrink their systemic footprint, reducing the harm that their failure would do to our financial system."[13] FHFA should give the Enterprises a similar choice – or, as Conservator, make that choice for them.

V. Counter-Cyclical Capital Buffer

FHFA should incorporate a rules-based, counter-cyclical capital adjustment in the proposed risk-based capital requirements.

As proposed, the risk-based capital requirements are pro-cyclical. This is due to the blunt use of mark-to-market loan-to-value ("LTV") ratios in the risk grids without any adjustment for changes in market conditions. Under the proposed capital framework, as home prices appreciate and LTVs fall, the Enterprises would be allowed to release capital. In other words, the capital requirements would decline in growing markets and would stimulate additional mortgage lending. Conversely, when home prices decline and LTVs increase, the Enterprises would be required to hold additional capital, potentially constraining new lending activity and withdrawing liquidity from an ailing market.

FHFA acknowledges the pro-cyclical impact of the proposed capital framework, but asserts that the use of mark-to-market LTVs would more accurately represent the Enterprises' current risk profile than would using original LTVs because the current value of a house influences both the probability that a homeowner will default on the mortgage and the magnitude of losses if a homeowner defaults.[14] In other words, not updating risk characteristics during a stress event could result in risk-based capital requirements being too low because original LTVs would be understated relative to mark-to-market LTVs that account for decreased home values during the stress event. FHFA also asserts that it can use its statutory authority to adjust capital to address the pro-cyclical impact created by the use of mark-to-market LTVs.[15]

We agree that there are shortcomings to using original LTVs in the risk grids. However, we also believe that the pro-cyclical impact of the proposed rule should be offset by an automatic, rules-based adjustment and not be addressed on a discretionary basis. Using discretion to address the pro-cyclical impact of the proposed rule could

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[13] Statement of Federal Reserve Board Chair Yellen, July 20, 2015, https://www.federalreserve.gov/newsevents/press/bcreg/yellen-statement-20150720a1.htm.
[14] 83 Fed. Reg. 33333, July 17, 2018.
[15] 83 Fed. Reg. 33325, July 17, 2018.

lead to untimely and inadequate adjustments in capital.[16] In contrast, an automatic, rules-based, adjustment could be applied consistently, in a timely manner, and would not be subject to political pressures.[17]

FHFA should seek public comment on a counter-cyclical capital adjustment.

To address the pro-cyclical impact of the proposed rule, and recognize changes in the value of housing prices, we recommend that the risk grids include an automatic adjustment tied to a reference measure for the fundamental, or long-term equilibrium, value of housing. To be clear, we are not proposing to modify the risk grids. We are recommending an adjustment that automatically would move the risk-based capital requirement up or down, based upon economic conditions.

Such an approach would require additional research. FHFA is well-situated to lead that effort, which could involve participation from academic, think tank, and industry participants. This is too important an issue to ignore. The pro-cyclical characteristics of the proposed capital framework, if implemented, would exacerbate losses and lengthen recovery time of the next downturn. Developing complex formulas would be less helpful than simply having a transparent and approximate basis for the capital framework to "lean against the wind" of house price changes; that is, a framework that would automatically lead to capital requirements rising as house prices increase past fundamental value and capital requirements that decline as house prices fall below fundamental value.

Efforts to solve this problem are underway. One potential reference measure would be the difference between current housing prices and a value for home prices that is derived from changes in per capita income. The National Association of Insurance Commissioners ("NAIC") is considering the application of such a model for mortgage insurers. The NAIC is using home prices in nine different regions of the country, but state level or even an MSA level may be a better basis for setting the reference rate. The FHFA itself has produced path-breaking research in this area. As FHFA's own analysts have found, the universal application of a counter-cyclical buffer can smooth out the swings in the housing market and eliminate the potential for housing bubbles.[18]

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[16] Michal Kowalik, *Countercyclical Capital Regulation: Should Bank Regulators Use Rules of Discretion?*, Economic Review, Kansas City Federal Reserve Bank, Second Quarter 2011, https://www.kansascityfed.org/publicat/econrev/pdf/11q2Kowalik.pdf.

[17] Brett McDonnell, *Designing Countercyclical Capital Buffers*, 18 N.C. Baning Inst. 123 (2013), https://scholarship.law.umn.edu/cgi/viewcontent.cgi?article=1169&context=faculty_articles.

[18] Scott Smith, Associate Director, Jesse Weiher, Senior Economist, Office of Capital Policy, Federal Housing Finance Agency, *Countercyclical Capital Regime: A Proposed Designed and Evaluation*, Working Paper 12-2, April 2012 ("If applied broadly to the mortgage market, the countercyclical capital regime could have significantly reduced the quantity demanded for housing, and thereby mitigated the amplitude of the house price bubble."), https://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/2012-04_WorkingPaper_12-2_508.pdf.

Whatever reference measure is selected, it should be transparent, be refreshed regularly, be validated by an independent authority, and be back-tested regularly. Finally, and most importantly, we urge FHFA to work with other state and federal regulators to ensure that the counter-cyclical buffer is applicable to mortgage credit held by any firm. The mark-to-market LTVs proposed in the framework, while generally consistent with a best practice preference to use current information in risk and capital calculations, are appropriate only if the stress scenarios to be applied simultaneously account for excesses in home price movements above and beyond inflation, income or other fundamental value considerations. Such an outcome would be a superior measure of risk and a built-in stabilizer in both rising and falling house price environments, while allowing for regional differences.

VI. Capital Comparability

The proposed capital framework for the Enterprises is the latest in a long line of capital standards proposed and/or issued by international, federal, and state financial regulators. Unfortunately, these various standards do not treat mortgage credit risk comparably. The same risk is subject to different capital charges depending upon the type of institution that holds the risk.

Attachment B illustrates these differences in the treatment of mortgage credit risk under different regulatory regimes. The table compares the capital charge applicable to a residential mortgage with an 80 percent LTV and a 750 FICO under the capital rules applicable to banks, mortgage insurers, and the Enterprises. Keep in mind that, while capital requirements should be comparable across charters, regulators also are expected to recognize structural and idiosyncratic risk differences across charter types and individual institutions, and also reflect differences in where, when, and how credit risk is realized and is, or is not, capped in any given arrangement.

The variability of the capital charges under these different regimes creates competitive imbalances between competing firms based upon differences in regulatory standards. It also results in misallocation of capital in those cases in which the capital charge is not aligned to actual mortgage credit risk.

Before finalizing the proposed rule, we recommend that FHFA engage other federal and state regulators to better align the capital charges for mortgage credit risk, regardless of the type of firm that assumes the risk. FHFA could use its participation on the Financial Stability Oversight Council (“FSOC”) to initiate such an effort since one of FSOC’s statutory duties is to facilitate information sharing and coordination among the member agencies and other federal and state agencies regarding domestic financial services policy developments and rulemaking.

VII. Other Recommended Changes to the Proposed Capital Framework

In addition to modifying the proposed capital framework to address the systemic risk posed by the Enterprises and to be counter-cyclical, the proposed capital

framework could be improved in certain other respects. Specifically, we recommend that: (1) the risk-based capital charges be based upon total losses over the life of a loan, both expected and unexpected; (2) the risk-based capital charges include a stressed revenue factor to capture the impact of future revenues; and (3) the Enterprises should be required to release details of their methodology for rating counterparties.

A. Expected and Unexpected Losses

The risk-based capital requirements should be based upon total losses.

The proposed capital framework has a muddled treatment of expected and unexpected losses. FHFA states in the preamble that the credit risk capital requirements are based on unexpected losses over the lifetime of mortgage assets, and that expected losses will be covered by guarantee fees.[19] However, market participants have no transparency into what the Enterprises or FHFA judge to be expected losses and no assurance that the fees actually will cover expected losses at all times. Expected losses are influenced by a number of factors, and the guarantee fees set by the Enterprises may or may not be sufficient to cover expected losses, especially in changing economic conditions. Similarly, different counterparties to the Enterprises may have unique calculations of expected losses – even on the same loan – and this can complicate pricing on transactions with the Enterprises and adversely affect competitive equity. Moreover, if the Enterprises underestimate expected or total loss relative to the rest of the market, their lower capital requirement will lead directly to that risk concentrating on their balance sheets.

The introduction of the Current Expected Credit Loss ("CECL") accounting standard in 2020 will further complicate the treatment of expected and unexpected losses. Under CECL, the Enterprises will be required to hold reserves against expected losses over the life of a loan. These expected losses would have to be recognized when the loans are acquired, and the Enterprises would be able to use their own forecasts and models for estimating the losses.

This muddling of the role of guarantee fees and capital could be eliminated by having the risk-based capital charges reflect both unexpected and expected losses. Therefore, we recommend that FHFA provide for the risk-based capital charge to reflect both unexpected and expected loss. This change would eliminate market confusion over the role of capital and the role of guarantee fees. Furthermore, to address the impending impact of CECL, FHFA should explicitly incorporate CECL in the design of the proposed capital framework. In doing so, FHFA could account for expected losses in the overall capital structure as the difference between the CECL reserve and the traditional incurred loss reserve. HPC recognizes that the implementation of CECL is under review, so the larger point here is that FHFA's proposed capital framework needs to align with the new accounting standard. When coupled with making a capital

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[19] 83 Fed. Reg. 33325, July 17, 2018.

framework based on total losses, not just unexpected losses, FHFA would reduce gaming made possible by any differences in the estimation of expected losses.

B. Stress Testing

Capital requirements based upon economic stress tests provide a basis for considering future revenue and achieving economic equivalency across regulated entities.

FHFA's look-up grids for mortgage credit risk are derived from stress tests that project losses under assumed stress scenarios (although, as previously noted, FHFA has not provided transparency into those estimates). Stress tests project future revenue and increased defaults, providing a comprehensive view of the impact of the stressed environment on capital.

Such an approach also allows the models to recognize differences in the characteristics of an entity's actual credit exposure, including where in the loss waterfall the exposure exists and the timing of the loss recognition. If credit risk is shared by multiple parties (e.g., an Enterprise and a private mortgage insurance company, or an Enterprise and a credit risk transfer counterparty), then the required credit risk capital should be appropriately distributed based on the relative risk exposure retained by each party plus an appropriate add-on if there is counterparty credit risk embedded in the risk-sharing structure. As discussed further below, that add-on should reflect counterparty strength of fulfilling its obligation.

Since FHFA and other federal and state regulators all utilize stress test models as key components of their capital frameworks, HPC urges FHFA to not only add transparency to its own modeling, but also to work with other regulators to enhance alignment across regulatory stress test assumptions and models. The fundamental credit risk assessment for a given loan should not depend on how that loan is financed. FHFA's access to the Enterprises' enormous historical loan-level data gives it an information advantage from which other regulators could benefit. Such a coordinated effort would enhance the overall calibration of capital requirements to credit risk but also enhance the likelihood of comparable capital treatment across regulatory frameworks for mortgage credit risk.

This connection between transparency in stress modeling and capital comparability extends beyond agency securitization. The return of a vibrant private label securities market also relies upon transparency in the agency space. Participants in the private label segment of the market rely upon baselines from the agency sector, and increased transparency in the underlying models used to create a capital framework for the Enterprises has direct utility to market evaluation of non-agency securitization.

C. Counterparty Risk

The proposed capital framework provides insufficient basis for judging counterparty risk.

The proposed capital framework adjusts the risk-based capital charges for the counterparty credit risk associated with third parties, including mortgage insurance companies and credit risk transfer counterparties. To account for this exposure, the proposed capital framework includes a counterparty haircut multiplier. The two main factors in determining this multiplier are creditworthiness of the counterparty and the counterparty's level of concentration in mortgage credit risk, which would be determined by the Enterprises based upon their own internal assessments. This approach to setting the counterparty charge lacks transparency and is based upon distinct, inconsistent internal assessments conducted by each Enterprise.

While the proposed capital framework includes a set of ratings, from one to eight, with eight assigned to a party in default, the ratings are subjective, based on internal measures and weights set by each Enterprise separately. This means that the same counterparty could receive different ratings from the two corporations. Further, by concealing the actual methodology from public view, either Enterprise can skew their ratings by applying alternative criteria at their own discretion, in a manner that would not be uniform for all counterparties. A counterparty subjected to unexpectedly low and/or disparate ratings across the two companies would not be in a position to appeal with confidence or to adjust their business profile to enhance their counterparty credit score, because the company would not know the actual measures used by each Enterprise.

FHFA makes the point that a critical rationale for rigorous counterparty assessment and ratings is to prevent a "correlation" of risk between an Enterprise and a particular counterparty. FHFA states that "correlation" could amplify rather than distribute risk exposure, as evidenced by the housing crisis. However, one could also argue that risk during the crisis was not amplified by correlation of the credit exposure, so much as by the deferral or delegation of credit risk management practices from one party to another, without a clear view into the quality and effectiveness of those practices. In other words, the concentration of risk management in a single entity, rather than across two counterparties, poses this type of risk. In fact, it would make sense to encourage more rather than fewer monoline entities, operating under balanced and clear contractual terms of agreement, incented to stay in the market across cycles, and subject to strong regulatory oversight.

It also should be noted that counterparty risk arises in connection with the CRT transactions. For CRT transactions that do not have cash set aside in trust but instead rely upon performance of the credit counterparty, the counterparty strength rating should reflect the risk that the counterparty fails to perform, which would increase the Enterprises' loss exposure.

To address the lack of transparency in the measures and weights behind the counterparty ratings for mortgage insurers and credit risk transfer counterparties, as

well as to address the discrepancy of the models across the two Enterprises, we recommend that FHFA require each Enterprise to release the criteria upon which they make these assessments for notice and comment to ensure that the criteria are sound, objective and consistent.

Alternatively, FHFA could establish, subject to public notice and comment, objective benchmarks for making these creditworthiness determinations. An example of how to do this is the Private Mortgage Insurance Eligibility Requirements (PMIERS), which provides a unified and objective baseline of creditworthiness that could be applied to all credit enhancers that expose an Enterprise to credit risk. Rating agencies, such as S&P and AM Best, also have developed standards for evaluating the strength of public companies and insurers, respectively. These standards involve a consideration of factors such as an institution's balance sheet, business profile, operating performance, and enterprise risk management, and could serve as a model for any standards developed by FHFA. The publication of such a standard by FHFA would help both counterparties and other market participants that are engaged in CRT transactions.

Providing for a transparent regulatory standard on assessing counterparty strength has utility beyond FHFA's regulatory concerns about credit counterparties to the Enterprises. In any post conservatorship world in which there may be new guarantors or issuers operating in competition with the Enterprises, having transparent factors for assessing counterparty strength would be critical in facilitating how a competitive market evolves.

VIII. Conclusion

HPC believes that the proposed capital framework is a good structure – relying upon granular capital charges based upon the risk characteristic of an individual mortgage plus capital set aside to cover other risks including market risk, operational risk, and model risk. Yet, the proposed capital framework needs significant refinement, and should be re-proposed. HPC has outlined four major areas for FHFA's consideration.

The first is for FHFA to direct the Enterprises to release those portions of their historical loan files that are still not public. These files count for half or more of the historical record, but, more importantly, reflect riskier loans and more adverse outcomes than what has been published to-date. With the release of this data, and the models and assumptions used, market participants can validate, or not, the credit risk assessments embedded in the look-up tables, which are critical to knowing whether and how the proposed capital framework actually reflects risk.

A second critical consideration for improving upon the proposed capital framework is for FHFA to eliminate the decidedly procyclical leaning of the framework by incorporating some reasonable measure of fundamental value that would make the framework counter-cyclical.

Third, as described in multiple places throughout this comment letter, FHFA should work with other prudential regulators so that the future capital framework applied in the secondary mortgage market treats comparable risks in a comparable way, whether those risks are mortgage credit risk for a given loan or systemic risk for the system.

Finally, the financial crisis ten years ago demonstrated beyond a doubt the deep systemic risk embedded in our housing finance system from concentrating so much risk, and the tools for measuring and managing that risk, in the Enterprises. Since then, that concentration has grown even more. The proposed capital framework falls well short of the buffer for systemic risk imposed on other systemically important financial institutions. This shortfall must be addressed. FHFA assumes that the proposed capital framework would apply to a post-conservatorship environment in which the Enterprises look and operate much as they do today. To protect our financial system from another systemic moment as encountered ten years ago requires far more than a 75-basis point going concern buffer or some material shifting of some of the activities of the Enterprises to other market participants.

Thank you for considering these comments. HPC looks forward to FHFA evaluating these and other comments received and then producing a revised framework for public review and comment.

Yours truly,

Edward J. DeMarco
President
Housing Policy Council

Attachment A
Responses to Selected Questions Posed by FHFA

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?

See Section II. Summary of Key Recommendations

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. Should FHFA consider reducing the pro-cyclicality of the proposed risk-based capital requirement? For example, should FHFA consider holding LTVs and/or other risk factors constant? What modifications or alternatives, if any, should FHFA consider to the proposed risk-based capital framework, and why?

See Section V. Counter-Cyclical Capital Buffer

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?

See Section IV. Systemic Risk

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?

See Section III. Transparency

Question 7: FHFA is soliciting comments on the proposed use of separate single-family credit risk capital grids for new originations and performing seasoned loans. The proposed new originations grid has a unique requirement for loans with an OLTV of 80 percent due to the volume of such loans, but this could lead to increases in capital requirements for loans originated with an OLTV between 75 percent and 80 percent when those loans season. Should FHFA consider combining the single-family new originations and performing seasoned loan grids? What other modifications should FHFA consider and why?

See Section V. Counter-Cyclical Capital Buffer

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?

See Section VII. C. Counterparty Risk

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?

See Section V. Counter-Cyclical Capital Buffer

Question 38: FHFA is soliciting comments on the advantages and disadvantages of the existing authority to temporarily increase minimum leverage requirements, in particular with respect to the view that use of this authority can serve a countercyclical role across economic cycles. FHFA is requesting data and supplementary analysis that would support alternative perspectives.

See Section V. Counter-Cyclical Capital Buffer

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

See Section V. Counter-Cyclical Capital Buffer

Question 40: FHFA is soliciting views on how best to identify periods of heightened market and Enterprise risk. In particular, what economic indicators or other triggers should be considered in determining when to require an adjustment to capital requirements and how such adjustments might impact capital planning?

See Section V. Counter-Cyclical Capital Buffer

Attachment B
Comparison of Capital Charges for 80 LTV/750 FICO Residential Mortgage Loan That Are Prudently Underwritten

Institution	Minimum Total Capital Requirement	Definition of Capital	Risk Weight	Effective Capital Charge
Standardized Approach Banking Organization	8% total capital to be adequately capitalized	Total capital includes common equity, retained earnings, perpetual noncumulative preferred shares, and approved subordinated debt instruments.	50%	4% or $4.00 per $100 in mortgage assets
Advanced Approach Banking Organization	10.5% total capital (8% for adequately capitalized plus a capital conservation buffer of 2.5%)	Same as above.	Determined by formula. 10% not unreasonable.[20]	Varies, but approximately 1% or $1.05 per $100 of mortgage assets not unreasonable
Impact of Collins Amendment on Advanced Approach Banking Organization	Under the Collins Amendment, the total aggregate capital for Advanced Approach banking organizations cannot be less than the total aggregate capital required for Standardized Approach banking organizations.	Same as above.	For AA banks, Collins only applies if Standardized Approach aggregate capital exceeds AA aggregate capital. Under Collins the implied risk-weight: 10—50% depending on other assets held by the bank.	Varies between $1.05 and $4.00.

[20] Based on discussions with large bank capital experts,

Institution	Minimum Total Capital Requirement	Definition of Capital	Risk Weight	Effective Capital Charge
G-SIB Banking Organization	Surcharge varies. For a 3.0% G-SIB surcharge, the total risk-based capital minimum is 13.5%[21]	Same as above.	Depending upon impact of Collins Amendment, which can vary depending upon many variables, the risk-weight for prudently underwritten mortgages can be between: 10%—50	Varies due to Collins. Between $1.35 and $6.50.
Impact of CCAR stress test			125% Based on TCH study.[22]	Implicit capital charge can be as much as $10 per hundred, using the 125% risk weight found in the TCH study.
Mortgage Insurance Company PMIERs Requirements[23]		Available assets less required assets. Available assets include cash, common and preferred shares, bonds, receivables and from investments.	Minimum of $400 million. Risk-based floor of 5.6% but may be higher depending on insured loan characteristics.	Minimum of $5.60 per hundred of insured amount of loans on a portfolio basis. Capital charge for any particular loan could be less, provided the 5.6 percent floor is met on an aggregate basis.
GSE Under Current Capital Rule (Current application is suspended)	Risk based capital required for residential mortgage credit of 2.50% for portfolio loans and 0.45% of guaranteed MBS.	Core capital includes common stock and perpetual noncumulative preferred stock. Total capital includes core capital and general	N/A Risk-weight is constant 100% but capital is adjusted by changing the capital charge.	$2.50 per hundred for portfolio assets $.45 per hundred for guaranteed MBS.

[21] Note that the Federal Reserve amendments proposed in April, 2018, may make significant changes to these capital requirements.
[22] "Capital Allocation Inherent in the Federal Reserve's Stress Test," The Clearinghouse, January 2017, p. 14. at Other studies have come to different conclusions. See, e.g. "The Impact of Stress Tests on Bank Lending", William F. Bassett and Jose M. Berrospide, Federal Reserve Board, September 1, 2017.
[23] PMIERs are requirements imposed on mortgage insurance companies seeking to do business with the Enterprises. At this time, the capital requirements under the PMIERs standards are the binding capital restraints.

Institution	Minimum Total Capital Requirement	Definition of Capital	Risk Weight	Effective Capital Charge
		allowance for "foreclosure losses."		
GSE Under Proposed Capital Rule	Based on risks of exposures at the end of 2017: Average Risk-based capital for residential loans is 2.73%, or $2.73 per hundred. Total average capital of 3.24% including all assets and exposures.	Same	Same	Base capital charge for high quality seasoned loan is $2.44 per hundred. Going concern and op risk surcharges of $.88. Total capital charge per hundred is $3.32.