NAHB
National Association of Home Builders

Housing Finance and Regulatory Affairs
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Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
8th Floor
400 7th Street, SW
Washington, DC 20219

RE: Enterprise Capital Requirements (RIN 2590-AA95)

Submitted by Electronic Delivery to http://www.regulations.gov and RegComments@fhfa.gov

Dear Mr. Pollard:

On behalf of the more than 140,000 members of the National Association of Home Builders (NAHB), I appreciate the opportunity to provide comments in response to the Federal Housing Finance Agency's (FHFA) Notice of Proposed Rulemaking (NPR) suggesting a new regulatory capital framework for Fannie Mae and Freddie Mac ("the Enterprises"). Though while the Enterprises remain in conservatorship they would be prevented from holding the level of capital that would be required if this proposed rule was finalized, it is extremely valuable to consider the nature and effects of a robust capital framework. Evaluating capital required under a rigorous framework will allow the Enterprises to measure the impact of business and pricing decisions and sets the stage for a capital regime that could be applicable to the Enterprises or their succeeding organizations after conservatorship and/or housing finance reform.

NAHB is a Washington DC-based trade association representing, among others, companies involved in the development and construction of for-sale single family homes, including homes for first-time and low- and moderate-income homebuyers as well as the production and management of affordable multifamily rental housing. The ability of the home building industry to meet the demand for housing, including addressing affordable housing needs, and contribute significantly to the nation's economic growth is dependent on a sound and efficiently operating housing finance system.

Background

The current capital standards for Fannie Mae and Freddie Mac were enacted by *the Federal Housing Enterprises Safety and Soundness Act of 1992* (Safety and Soundness Act). The Safety and Soundness Act established minimum capital requirements in the form of a leverage ratio and a risk-based capital requirement that required the then-regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), to establish a prescriptive risk-based capital stress test. The Safety and Soundness Act also required the regulator to issue a statutorily defined capital classification of Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, or Critically Undercapitalized for each Enterprise on a quarterly basis. These capital requirements were suspended when FHFA, the Enterprises' new federal regulator established under the *Housing and Economic Recovery Act* (HERA) of 2008, placed the Enterprises in conservatorship in 2008. Any new capital requirements finalized by this rulemaking would supersede those put in place by OFHEO but would remain suspended while the Enterprises are in conservatorship.

FHFA issued the NPR to start the conversation on how much capital a reformed Fannie Mae and Freddie Mac would need to be adequately capitalized if they were to remain relatively intact in a reformed housing finance system. The finalized requirements are expected to be used for informing the setting of guarantee fees and other prices and assessing the effect of business decisions on the organizations.

FHFA has emphasized the rule is not intended to be seen as advocating for a certain outcome or connected to discussions about recapitalizing the Enterprises.

Current Statutory and Regulatory Capital Requirements

The minimum capital requirements established by the Safety and Soundness Act require the Enterprises to maintain minimum capital that is greater than or equal to:

- 2.5 percent of on-balance sheet assets, which include mortgage-backed securities (MBS), mortgage loans, and other investments the Enterprises hold in their respective investment portfolios;

- 0.45 percent of the unpaid principal balance of outstanding MBS not included in on-balance sheet assets, which include MBS the Enterprises issue and guarantee, but do not own and hold in their investment portfolios; and,

- 0.45 percent of "other off-balance sheet obligations."

The rules for establishing risk-based capital as required by the Safety and Soundness Act directed the regulator of the Enterprises to take into consideration each Enterprise's overall portfolio, a stressed market environment, and the effectiveness of its risk management practices. OFHEO took almost 10 years after the passage of the Safety and Soundness Act to develop and finalize the stress test regulation that would determine the amount of risk-based capital to be maintained. The risk-based stress test simulates the effects of 10 years of adverse economic conditions on the existing assets, liabilities, and off-balance sheet obligations of the Enterprises to determine, as of a fixed point in time, how much capital each Enterprise would require to survive the economically stressful conditions of the test.[1] The stress test was in effect for years 2002-2008.

Though the Enterprises have not been bound to maintain their statutory and regulatory capital requirements or be assigned a capital classification of Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, or Critically Undercapitalized while in conservatorship, FHFA continues to require the Enterprises to calculate and report quarterly the difference between its capital reserve and the minimum statutory capital requirement as well as the difference between the statutory minimum capital requirements and core capital. As of year-end 2016, the difference between Fannie Mae's calculated minimum statutory capital and core capital Fannie Mae was deficient by $136.2 billion, i.e. to meet the minimum capital requirement for the Adequately Capitalized standard under the Safety and Soundness Act, Fannie Mae would have required an additional $136.2 billion.

At the same point in time, Freddie Mac would have required an additional $86.7 billion to meet the minimum capital requirement for the Adequately Capitalized standard under the Safety and Soundness Act. This is not

[1] "Existing Statutory Capital Requirements for Fannie Mae and Freddie Mac", Federal Housing Finance Agency Office of Inspector General, August 17, 2017, Pp. 7-8.

unexpected since the current conservatorship agreement between FHFA and the U.S. Department of the Treasury (Treasury) allows the Enterprises to hold only $3 billion each in capital.

In addition, the Enterprises remain obligated to perform the stress test process required by the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (Dodd-Frank Act) and report the results to FHFA. The Dodd-Frank Act requires certain financial companies with consolidated assets over $10 billion that are supervised by a federal regulator to comply with the stress test provisions of the Dodd-Frank Act. The Dodd-Frank Act stress test (DFAST) is intended to determine whether an institution has the capital necessary to absorb losses during a sustained period of adverse economic conditions. The Federal Reserve Board releases distinct economic scenarios that institutions input into their models to gauge their capital adequacy for absorbing the losses as calculated in the depicted stress scenarios. The results of the stress test are reported, but do not trigger corrective action.

Though the Enterprises currently are limited to holding only $6 billion in combined capital reserves, monitoring how deficient their actual capital is from the minimum capital as per the Safety and Soundness Act requirements is valuable for determining the impact of changes to guaranty fees, mortgage purchases and other business decisions. Regardless of the current requirements and restrictions placed on the Enterprises by FHFA and Treasury, FHFA, as regulator, remains responsible for considering adequate capital levels for the Enterprises and considering a suitable capital regime for future housing finance entities that it may regulate. FHFA defines the overall goals of conservatorship as helping restore confidence in Fannie Mae and Freddie Mac, enhancing the Enterprises' capacity to fulfill their mission, and mitigating the systemic risk that contributed directly to instability in financial markets.

Conservatorship Capital Framework

In 2017, FHFA directed Fannie Mae and Freddie Mac to implement a conservatorship capital framework (CCF), an overall risk measurement framework for evaluating the Enterprises' risk management and business decisions while they are in conservatorship to ensure they are making prudent business decisions. FHFA uses the CCF to assess the Enterprises' guarantee fees, activities, and operations and to guard against the Enterprises making competitive decisions that could adversely impact safety and soundness. The Enterprises are required to submit quarterly reports to FHFA relating to the framework’s requirements. FHFA, in its capacity as conservator, provides guidance relating to the guaranty fee pricing for new single family acquisitions and requires that Fannie Mae and Freddie Mac meet a specified minimum return on equity target based on the CCF. The target was effective in the first quarter of 2018.

Proposed Rule

The CCF is the basic foundation for the proposed rule, which also generally is consistent with the regulatory framework for large banks imposed under Basel. Accordingly, the NPR notes that FHFA has taken into consideration the unique monoline businesses of the Enterprises with assets and guarantees heavily concentrated in residential mortgages and risk profiles that differ from large diversified banks. Comments on the NPR potentially will help FHFA refine the CCF, which will continue in effect until conservatorship ends.

The NPR introduces two alternative approaches for determining leverage or minimum capital and proposes a new framework for calculating risk-based capital. The proposed risk-based capital framework requires the Enterprises to calculate capital for credit risk, market risk, operational risk and a going-concern buffer for both

single family and multifamily assets and guarantees. The combined total of these calculations plus risk-based capital calculations for private-label securities (PLS), commercial mortgage-backed securities (CMBS), deferred tax assets and other miscellaneous portfolio assets is the aggregate risk-based capital requirement.

The alternative approaches for minimum capital are straightforward calculations of either 2.5 percent of total assets and off-balance sheet guarantees or 1.5 percent of trust assets plus 4 percent of non-trust assets. The Enterprises would be required to meet the higher of the calculated minimum capital or risk-based capital.

Proposed Risk-based Capital Calculations

Credit Risk for Whole Loans and Guarantees

Proposed credit risk requirements for single family whole loans and guarantees would be determined using a baseline credit risk calculation that would be adjusted up or down using "risk multipliers" that reflect additional risk factors to determine a gross credit risk capital requirement. The risk multipliers would be based on individual loan characteristics that are considered to increase or decrease the riskiness of a loan. Net credit risk capital requirements would be determined by adjusting for the benefits provided by loan-level credit enhancements including mortgage insurance, and various repurchase, replacement, recourse, and indemnification agreements which would vary by loan segment and any "haircut" adjustments to account for counterparty credit risk. Counterparty credit risk would be determined by FHFA's internal rating of the financial strength of a counterparty. Once the credit risk capital requirements for all assets are aggregated to arrive at an "aggregate net credit risk capital requirement", this would be reduced by giving credit for any credit risk transfer structure based on an extensive, five-step credit risk transfer calculation.

Like the calculation for credit risk capital for single family whole loans and guarantees, required credit risk capital for multifamily whole loans and guarantees would be determined using a set of base grids and risk multipliers that capture the unique nature of multifamily lending and its particular risk drivers. Importantly, segments of single family and multifamily loans or guarantees include a mark-to-market loan-to-value (MTMLTV) in the risk factors. The proposed rule attempts to account for differences in the Enterprises' multifamily business models, particularly as they relate to the structure of their credit risk transfer transactions.

Market Risk

The proposed market risk capital requirement provision focuses primarily on accounting for the spread risk associated with holding different assets in the retained portfolio, including single family and multifamily whole loans, PLS, CMBS and other assets with market risk exposure. Spread risk is the risk of a loss in value of an asset relative to a risk free benchmark due to change in perceptions of performance or liquidity. The FHFA acknowledges that the Enterprises also are exposed to interest risk but have historically hedged interest rate risk through the use of callable debt and derivatives.

The proposal establishes three approaches to determining the market risk capital requirement each tailored to the Enterprises' businesses: a single point estimate; a spread duration approach that defines market risk capital by multiplying a spread shock by a spread duration generated from an Enterprise's internal model; and exclusive use of an Enterprise's internal models. Calculations for market risk capital for single family whole loans and guarantees would use single point estimates and the Enterprises internal models. For multifamily whole loans, the calculation would use a spread duration approach which relies in part on the Enterprises' internal models.

Operational Risk

The proposed operational risk charge would be calculated by multiplying the unpaid principal balance of assets and guarantees with credit risk by eight basis points. For assets with market risk, the eight basis points would be multiplied by the market value of the asset; and for assets and guarantees with credit and market risk, the eight basis points would be multiplied by the unpaid principal balance of the asset.

Going-Concern Buffer

The proposed going-concern buffer, which is intended to provide the Enterprises with sufficient capital to continue operating for one to two years after a stress event without external capital support, would be calculated by multiplying the unpaid principal balance of assets and guarantees with credit risk by 75 basis points. For assets and guarantees with market risk, the 75 basis points would be multiplied by the market value of the asset and guarantee; and for assets and guarantees with credit and market risk, the 75 basis points would be multiplied by the unpaid principal balance of the asset or guarantee.

Proposed Alternatives for Minimum Leverage Capital

The two alternatives being considered for determining minimum capital are:

1. The Enterprises would hold capital equal to 2.5 percent of total assets and off-balance sheet guarantees. This approach would be consistent with Basel leverage capital requirements for banks and would require the Enterprises to hold a minimum amount of capital for assets and guarantees that does not differentiate between the risk-characteristics of assets and guarantees.

OR

2. The Enterprises would hold capital equal to 1.5 percent of trust assets and 4 percent of non-trust assets. This approach differentiates between greater funding risks of the Enterprises' non-trust assets and the lower funding risks of the Enterprises' trust assets and would increase the capital requirements for both Enterprises relative to the current statutory requirements.

NAHB Comments

Adequate capital is critical to any business. Capital is necessary to absorb losses and allow a business to remain in operation for a period of time when it has experienced expenses in excess of revenue. NAHB agrees this is true for the Enterprises and it is appropriate for FHFA, as both regulator and conservator of the Enterprises, to consider a robust capital regime for the Enterprises to fully inform decisions regarding mortgage pricing and business operations. We applaud FHFA for taking a proactive approach to establishing a capital regime for the Enterprises that would inform and guide current business decisions. NAHB also appreciates FHFA's determination that the proposed capital requirements would not apply to the Enterprises while they remain in conservatorship.

FHFA's proposal also will contribute to housing finance reform discussions since adequate capital requirements will be a key area of concern for the Enterprises' post-conservatorship or any successor entities.

However, in the absence of a timeframe or definitive framework for comprehensive legislative reform of the housing finance system, and with no clear determination of the future of the Enterprises, NAHB believes it is premature to finalize a new, revised capital regime. NAHB recommends that FHFA's proposal serve as a first step in an iterative process. FHFA should consider the comments received on this NPR and respond to those comments with a revised proposal and a second opportunity for stakeholder comments. The NPR process can continue as necessary until all significant concerns or questions have been addressed. Since the capital rule would not go into effect while the Enterprises are in conservatorship, NAHB does not believe this is a process that should be rushed. A final rule prior to knowing the final structure of the Enterprises post-conservatorship does not seem necessary or practical.

NAHB's main concern regarding the proposal is that it would unnecessarily increase benchmark capital standards for Fannie Mae and Freddie Mac and directly lead to increased financing costs or more limited credit availability for borrowers. NAHB believes that access to affordable and sustainable credit for home buyers and multifamily developers should be available during all economic cycles.

FHFA's conservative approach could require the Enterprises to hold more capital than necessary.

NAHB is concerned that the proposed approach, taken as a whole, would cause the Enterprises to hold excess capital. In many areas where FHFA made decisions impacting the level of capital, the agency chose the route that would effectively include an extra cushion of capital. NAHB believes that FHFA should consider the cumulative effect of the capital calculations to determine if the Enterprises would be holding more capital than needed, as this would unnecessarily drive up costs and limit financing options for borrowers.

The proposed credit risk multipliers in the base grids for new originations are designed to account for a decline in house prices comparable to declines in the 2008 financial crisis. We believe regulatory and statutory changes to mortgage underwriting standards have improved the quality of new loan purchases and the assets in the Enterprises' retained portfolios since the crisis. NAHB believes these improvements have made the base factors in FHFA's proposed grids overly conservative and, therefore, may not be the best benchmark to use to determine future capital requirements.

FHFA's procyclical approach may hamper the Enterprises' support for the housing market in times of economic stress.

NAHB is concerned that a procyclical approach has been used as the basis for determining capital requirements. NAHB believes a procyclical approach to the capital requirement is not appropriate as it would decrease the ability of the Enterprises to remain in the marketplace during all economic cycles. NAHB very much supports the countercyclical role the Enterprises played in the most recent financial crisis by providing liquidity and access to credit when many other players left the market.

In the most recent downturn, Fannie Mae and Freddie Mac played a significant role in the government's response to stabilizing the economy. They were critical to the continued availability of single family mortgage credit and multifamily financing throughout the crisis and also provided essential assistance to distressed homeowners. According to FHFA's second quarter 2018 *Foreclosure Prevention Report,* the Enterprises have completed over 4 million foreclosure prevention actions since September 2008. Of these actions, almost 3.5 million have helped troubled homeowners stay in their homes, including about 2.2 million permanent loan modifications.

Similarly, data shows that during the downturn Fannie Mae and Freddie Mac provided capital for multifamily production when private capital was not readily available. The Enterprises' share of the multifamily market was 70 percent in 2009, but retreated as the availability of private capital returned to the market.

Importantly, the Enterprises' multifamily portfolio performs exceptionally well, and even during the most recent downturn the high-quality of their underwriting and risk management practices was evident. Between 2006 and 2017, the highest delinquency rate for Fannie Mae was .7 percent and for Freddie Mac was .3 percent, both in 2010. This translates to credit losses of 26.6 basis points for Fannie Mae and 9.6 basis points for Freddie Mac.

Using mark-to-market loan-to-value (MTMLTV) to calculate risk-based capital on both the single family and multifamily portfolios, as proposed, would create a procyclical role for the Enterprises. Under the proposal, as the market ramps up and house prices increase, MTMLTVs would fall, indicating a requirement for less capital. During these times, as the Enterprises set guarantee fees, they would likely be charging a decreased guarantee fee potentially leading to inadequate life-time capital held for loans purchased during this time. In times of deteriorating house prices, when higher MTMLTVs would signal a need for more capital, guarantee fees likely would have to rise in order to build up capital. Raising capital in stressed market conditions would be difficult to implement and likely would cause further market disruptions. The Enterprises would be left with less capital in an already soft economy to support the housing market.

To counteract a potential mismatch of capital due to MTMLTV calculations, FHFA references that minimum leverage capital requirements would mitigate the indicated decrease in capital if risk-based capital were to fall below leverage capital. FHFA also refers to its authorization to increase or decrease capital requirements by regulation or order if it believes such a step becomes necessary to prevent negative repercussions of procyclical capital requirements.

NAHB cautions FHFA not to rely on this regulatory authority as a back-up plan for adjusting capital when the minimum leverage and risk-based capital calculations appear out of alignment with FHFA's own market assessment. Even though FHFA may have the authority to raise capital in times of stress, it may not be economically or politically feasible to do. In fact, based on the federal government's actions during the most recent financial crisis, Fannie Mae and Freddie Mac would more likely be asked to deplete capital to develop programs that would stabilize the economy in a future economic downturn.

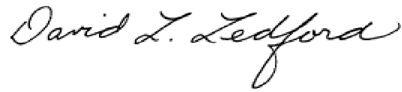
NAHB believes using a MTMLTV to calculate risk-based capital would cause volatility in the capital of the Enterprises and also cause less capital held to cover lifetime capital on loans originated during periods of house price appreciation. In other words, NAHB does not believe the Enterprises' capital requirement should be tied to house price appreciation. Using original loan-to-values would provide a stable capital requirement.

Conclusion

With the Notice of Proposed Rulemaking for Enterprise Capital Requirements, FHFA has focused attention on an important structural factor of the current and future housing finance system. NAHB appreciates FHFA's first step in this process and we look forward to working with FHFA and industry stakeholders to improve the proposal as these discussions evolve.

Thank you for your consideration of NAHB's comments. For more information, please contact Rebecca Froass, Director of Financial Institutions and Capital Markets at rfroass@nahb.org or Michelle Kitchen, Director of Multifamily Finance at mkitchen@nahb.org.

Sincerely,



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