

November 16, 2018

Alfred M. Pollard
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Federal Housing Finance Agency
400 Seventh Street, SW
Eighth Floor
Washington, DC 20219

Attention: Comments RIN 2590-AA95

Dear Mr. Pollard:

The American Bankers Association appreciates this opportunity to offer comments on the Federal Housing Finance Agency's (FHFA) proposed rule on Enterprise Capital Requirements, which includes a new framework for risk-based capital requirements and two alternatives for an updated minimum leverage capital requirement.

Introduction

Although the Enterprises (Fannie Mae and Freddie Mac) have been operating essentially without capital under terms of their conservatorship, we share FHFA's view that the proposal of a capital rule to govern the Enterprises is a valuable undertaking. Managing the GSEs to an appropriate capital standard provides discipline over what activities are undertaken by the Enterprises, and the degree to which they engage in certain transactions, such as credit risk transfers. Indeed, ABA has long advocated that appropriate capital standards are an essential element not only to ensure the financial viability of the Enterprises but also as a management tool to ensure that their activities are appropriately limited to the defined and directed role assigned to them in the secondary mortgage market. Additionally, the proposal of new capital standards provides an official forum for public input and discussion of the proper roles played by the Enterprises going forward, and the level of capitalization that should be required for the various risks involved in those roles. Such a public discussion with input from impacted parties and market participants should prove useful to policy makers generally, and specifically to legislators as they undertake reform legislation. While the legislative process does provide for public discussion and input on these issues, it has thus far not resulted in a satisfactory consensus approach for reform of the Enterprises. This forum provided by FHFA's official notice and comment on detailed capital proposals from the regulator of the Enterprises is an opportunity to focus attention on specific activities undertaken by the Enterprises and the risks associated with those activities. We appreciate the opportunity to provide comments and hope that they will prove useful both in the ongoing management of the Enterprises, and in guiding the future direction of the Enterprises and the government's role in the secondary mortgage market.

We must also note, however, that the specific capital proposal, while useful in focusing public and industry participant attention on Enterprise capital regulation, is of limited use until we know the future structure and mission of the GSEs. This is not to understate the usefulness of the proposal in guiding that direction, but an acknowledgement that future structures and missions assigned to the Enterprises, if indeed the Enterprises even continue in their current form, is an open question. As we have seen from legislative proposals in recent years, Congress has considered significantly different structures for carrying out the government's role in the secondary market. The Johnson/Crapo and Corker/Warner bills considered by the Senate Banking Committee would have divided the functions of the Enterprises among several separate entities, each of which would require a different capital structure appropriate to the specific risks undertaken by each of those entities. Similarly, proposals introduced or discussed in the House would entail significantly different roles and structures for the government in the secondary mortgage market. The most recent discussion draft proposed by Representatives Hensarling, Delaney and Himes would shift the provision of the federal guarantee to Ginnie Mae, while providing significant credit enhancement from private market participants. Such a structure would require different capital requirements for each of these entities attendant to the activities they undertake and the risks associated with those activities. Nevertheless, regardless of the structures or duties and limits ultimately chosen by Congress (which we maintain must be the ultimate arbiter of the future direction of the government's role in the secondary mortgage market), it seems likely that certain broad functions and attendant risks assigned to the Enterprises or their successors will not change dramatically. They will remain focused on housing finance and the provision of a federal guarantee, while offsetting risk through credit risk transfers and other mechanisms. With that in mind, as well as the acknowledgement of the limits of the applicability of the specific proposal on the table, we offer the following comments and constructive criticisms.

General Comments

FHFA is proposing a regulatory capital framework for the Enterprises that would implement two components: A new framework for risk-based capital requirements and a revised minimum leverage capital requirement specified as a percentage of total assets and off-balance sheet guarantees. While conceptually similar to the framework for large banking organizations, the overall requirements are significantly lower than those that apply to banks. The FHFA proposal also lacks the unreasonable and unnecessary complexity of bank capital rules where large banks are subject to 24 different capital measures. The simpler approach taken by the FHFA is not a flaw, but rather a strength.

Balancing risk based and leverage:

In establishing risk-based capital requirements and updating the minimum leverage requirement, FHFA is seeking to ensure that the two sets of requirements complement one another. A sound capital management and supervisory program makes appropriate use of both risk-based and leverage capital measures, an approach adopted by all U.S. banking regulators and mandated by statute in the wake of the S&L crisis. Risk-weighting of bank assets is imprecise, but it is an art

that has shown valuable progress over the years. It avoids the proven dangers of treating all risks the same (under which safer banks are required to hold too much capital, and unsafe banks may be able to pass with too little). To counteract the model uncertainties of risk-based capital systems, however, as well as to ensure capital for risks that are either unknown or unknowable, a foundation of leverage capital is merited. That is the structure that regulators and bankers rely upon today. It is demonstrably superior to rely on either risk-based or risk-blind measures alone. The FHFA is on the right path striking the balance between leverage and risk-based capital standards by establishing a leverage ratio requirement that operates as a backstop.

Risk based capital requirements:

Although distinct and lower than bank capital requirements, ABA believes that the FHFA is looking at the right risk factors in establishing the proposed risk-based capital framework. Credit, market, and operational risk are key factors in any financial firm's measure of safety and soundness. That said, we believe the FHFA should consider how to measure concentration risk, and potentially develop capital requirements for it. The Enterprises are monoline businesses with assets and guarantees heavily concentrated in residential mortgages with specific risk profiles. While this concentration occurs because of the nature of the Enterprises' charters, it is worth noting that no large banking organization would be allowed to operate in similar fashion when so thinly capitalized.

We also recognize that the government has an interest in advancing the goal of broad availability and affordability of mortgages for the widest range of qualified borrowers—goals ABA and a wide range of industry participants support. That support should not, however, subject the taxpayers to undue risk from capital standards that are set too low, or from guarantee fees that do not appropriately reflect the cost of the guarantee being provided. Therefore, while our more specific comments that follow focus on how FHFA can improve the capital proposal to provide for a stronger capital regime, we also accept that there is a necessary balance between an ideal capital structure to protect taxpayers, and a desire to achieve a regime that protects taxpayers adequately while also extending a benefit to potential homebuyers.

We also want to raise a general caution about the application of any final capital standards to the current operations of the Enterprises, even while in conservatorship. While it is important to establish strong, workable capital standards, and to govern the Enterprises in a fashion that adheres to them, we urge FHFA to be cautious not to let “phantom capital” be a driving force that undermines or curtails programs and activities that the market finds useful. That is not to say that the FHFA should allow programs or activities that expose the Enterprises to undue risk, but it also should not curtail popular and effective programs and activities, or force major changes to those activities, to meet a capital standard that is not actually protecting taxpayers. FHFA should continue to use its regulatory powers to ensure that activities and programs undertaken by the Enterprises are mission appropriate, and should not use capital standards as a substitute for those other powers.

We want to note and commend the FHFA for the proposal's general treatment of the credit risk transfer mechanisms which have been developed (at the direction of FHFA) in recent years. We do have concerns that the proposal may provide for lower capital treatment than is warranted from the employment of credit risk transfers, and our specific comments note both those concerns and the relatively high costs incurred by the Enterprises in the initial transactions. We recognize that these are reflective of the costs of establishing this market, and we are encouraged by the inclusion of the general treatment of credit risk transfers in the capital calculations, as these mechanisms are an important innovation which have shown great potential to reduce risks borne by taxpayers. They should be fostered and encouraged, and we are pleased that the proposed capital structure does so, even as we do offer recommendations for improvements to the capital treatment of these transactions.

Specific Comments

Comments address components of the framework and the Table of Contents and tables listed in the Federal Register on Tuesday, July 17, 2018¹

1. Minimum Leverage Capital Requirements

The FHFA seeks comment on two alternative leverage capital ratios:

1.A The "2.5% Alternative" calculated as 2.5% of total assets (GAAP assets); and

1.B The "Bifurcated Alternative" calculated as 1.5% of "Trust Assets" (outstanding Fannie Mae MBS and Freddie Mac PCs held by third parties), plus 4% of "Non-Trust Assets" (Total GAAP assets plus off-balance-sheet assets related to securitizations, minus Trust Assets).

We will address the alternatives in turn.

1.A The 2.5% Alternative minimum leverage ratio

It is a useful exercise to compare this with previous minimum capital ratios of the Enterprises as well as similar mortgage-concentrated financial companies that have experienced financial distress at minimum leverage ratios approximating 2.5%, and to discuss why the previous capitalization ratios proved inadequate. The list below is not meant to be exhaustive:

Fannie Mae in the late 1970s through 1982—Fannie Mae, similar to some thrift institutions, has a balance sheet of largely fixed-rate mortgages funded by agency debt. With the rise in interest rates in 1979, Fannie Mae suffered from a severe balance sheet mismatch, with loan rates at 10.5% and its marginal cost of borrowing at 11%. At the end of 1981, Fannie Mae had \$62.1 billion in assets and \$1.3 billion in equity, a leverage

¹ All footnotes are intended for benefit of the ABA team. I leave it to your discretion to include, embed in the document or toss out.

ratio percentage of 2%. Fannie leadership represented that they were well-capitalized. Forbearance and favorable tax actions by the U.S. government allowed Fannie Mae, and to a lesser extent Freddie Mac, to grow out of its situation. This growth was aided by the rapid expansion of mortgage securitization and severe distress among banks and thrifts that were competing mortgage portfolio lenders.

Thrift institutions in the late 1970s through the early 1980s—Similar to the Enterprises, hundreds of thrift and banking institutions experienced balance-sheet mismatches due to interest-rate risk problems. The institutions were largely mortgage lenders holding loans in portfolio. In October 1982, the Garn-St. Germain Act empowered various regulatory agencies to take intervention at thrift institutions. The law, among other things, gave Federal regulators powers to liquidate or merge troubled institutions, or to purchase equity in institutions with net worth ratios of less than 3% and as little as 1% capital-to-assets. Objectively, allowing institutions to remain operating with as little as 2.5% minimum capital allowed problems to grow, including a worsening of credit problems (some institutions were able to successfully raise capital or grow out of their problems), but the history of mortgage lenders with 2% or 3% capital eventually enabled a situation from 1989 -1994 that required government intervention costing the U.S. taxpayers in excess of \$125 billion and the closing of hundreds of thrift institutions.

FHA Mutual Mortgage Insurance (MMI)—The MMI fund is the FHA’s largest single-family guaranty fund, and has been plagued by problems intermittently since the 1950s. The funds have had various minimum capital reserve ratios, usually 2% or more. Backed by the federal budget, MMI does not have capital in a way that is comparable to a financial institution. FHA is a mortgage insurer and, as such, is not a perfect analog to the Enterprises (FHA takes a “first loss” credit position and generally serves low-down-payment, low-income borrowers). The MMI’s experience is still instructive: even in periods where the MMI has had more than 2% “reserves,” it encounters financial strain and required U.S. government assistance as recently as 2012.

The three examples cited above are, of course, not directly applicable to FHFA’s proposed rule on Enterprise capital. The rule is intended primarily to develop an aligned risk management framework to better evaluate each Enterprise’s business decisions while they are in conservatorship, and risk-taking purposefully has been attenuated under the conservatorship. The problems reflected in the examples were clearly affected by risk-taking of types and levels not permitted under the current conservatorships. That said, the conservatorships are often viewed as a laboratory of institutional development and reform that might affect the form of housing finance reform to come. This laboratory is helpfully illuminating options for future housing policy decisions. Therefore, consideration of past crises can inform the robustness of the proposal, or transferability to different situations in a post-conservatorship world.

The Enterprises have a 2.5% of on-balance-sheet assets capital requirement as mandated in the 1992 Federal Housing Enterprises Financial Safety and Soundness Act. The 2.5% Alternative

proposed herein merely would extend the 2.5% requirement to off-balance sheet activities (the guarantee business and OBS exposures previously had a 0.45% requirement minimum by law).

The proposed 2.5% Alternative is scarcely better than the 1992 minimums. As illustrated in Tables 1 and 3 of NPR, the two Enterprises (Fannie and Freddie, respectively) had Net Worth as of 12/31/2007 of 1.4% and 1.2% of total assets and OBS guarantees. The Enterprises were in federal conservatorship by September 2008. The peak capital losses shown in the same two tables is more than twice the capital the Enterprises had 12/31/2007. It is worth noting that these losses were entirely due to credit events.

The 2.5% Alternative seemingly is inadequate as a minimum in a non-conservatorship world, and the FHFA itself recognizes that the previous statutory minimum leverage ratios from 1992 of a 2.5% on-balance-sheet minimum and 0.45% of off-balance-sheet obligations “much too low to be safe and sound.”² A minimum leverage requirement implies some sort of brake on the risk-taking activities of a business, but that is applied by regulation in conservatorship. Therefore, what might serve as an effective “risk measurement framework” under conservatorship well might not be an effective risk management framework under differing circumstances.

Notwithstanding possible changes of circumstances, a more general comment speaks to the NPR’s Questions 30 through 32. The 2.5% Alternative depends on an underlying presumption that the Enterprises’ risk-taking is significantly lower than that of a bank or other financial institution. We do not necessarily dispute that finding, but note that the Enterprises take significant risks on many types of exposures and also have complex balance sheets, guarantee, and hedging activities. The minimum leverage requirement for a bank is twice as high. By comparison, a different housing GSE structure, the Federal Home Loan Bank System (FHLBs) has a minimum leverage ratio of 4%, even though their primary business is making over-collateralized loans to well-capitalized member financial institutions. This suggests a higher minimum leverage ratio for the Enterprises. The successful performance of FHLBs during the great recession depended in part of its higher capitalization requirements.

1.B The “Bifurcated Alternative”

Our comments on the Bifurcated Alternative follow from our comments on the 2.5% Alternative. While it is correct to recognize that on-balance-sheet assets warrant a more bank-like capital ratio (4%), an important distinction should be drawn between a bank holding loan assets and the Enterprises, in that the Enterprises hold mortgage assets with a yield that is net of a g-fee and a servicing fee, meaning their loss absorbing capacity is lower in comparison. Four percent of balance sheet assets may be not an adequate minimum.

² Page 33384 Federal Register/Vol. 83, No. 137

Additionally, the Enterprises use their balance sheets to hold modified and re-performing loans purchased from MBS outstanding, as well as REO. Having a too-low Bifurcated ratio—and a too large difference in the ratios may encourage the Enterprises to take risks on asset exposures that have favorable treatment, and subsequently transfer these assets back to the balance sheet. We also suggest reviewing the proposal of the Enterprises’ “Trust” business, which in essence is selling credit and payment coverage on mortgage risk; the Enterprises take credit risk on the guaranty book of business and ensure timely payment of P&I. The 1.5% requirement on “Trust Assets” is low in comparison to the FHA MMI fund (2%), or private mortgage insurers with whom the Enterprises do business, who struggled to hold 4% capital during recent crisis and have raised capital levels since the financial crisis.

FHFA provided a comparison of the 2.5% Alternative and the Bifurcated Alternative (using adjusted 9/30/2017 balances, in Table 7 of the NPR, which we partially present here:

2.5% Alternative	Enterprises Combined (\$billions)
	\$139.5 B

Bifurcated Alternative Enterprises Combined (\$billions)

Non-trust Assets – 4%	\$31.6 B
Trust Assets – 1.5%	<u>\$71.8 B</u>
Bifurcated Total	\$103.5 B

As shown, the Bifurcated Alternative sets the bar even lower than the 2.5% alternative. The combined percentage shown on Table 6 for the Bifurcated Alternative is 1.9%. We would suggest that if a Bifurcated Alternative were used as a minimum leverage approach, the blended leverage level be not less than that calculated under the Alternate approach.

2. Risk-Based Capital Requirements

The FHFA has done impressive work on the risk-based proposal. The extensive comments that follow do not necessarily indicate that the proposed capital regime is unsuitable, but we have many specific comments.

Before we begin our comments, let us bear in mind that the Enterprises previously had a RBC regime as required by the 1992 law and finally implemented in 2002. The model was a stress test of credit and simultaneous interest rate risk. In March 2002, Fannie Mae commissioned a research paper by several experts, including a Nobel-prize winning economist, and the paper, which address both of the Enterprises concluded that the probability of shocks as severe as those captured in the 2002 OFHEO model were “conservatively one in 500,000 and may be smaller

than one in three million.”³ The events ultimately never occurred, as there was no interest rate shock as contemplated and simulated in the model, so the authors were technically correct. Still, the Enterprises have been in conservatorship for ten years. We point this out to suggest that a considerable amount of caution and humility is required in commenting on scenarios that seldom occur as planned.

We will address our comments, and address the questions in the NPR, by order of importance to:

- a) Single-family credit risk (including risk multipliers and credit enhancement)
- b) SF credit enhancement and counterparty risk
- c) Multi-family credit risk (including risk multipliers and credit enhancement)
- d) Market risk
- e) Other assets and guarantees
- f) The going-concern buffer
- g) Credit risk transfer (to other than mortgage insurers)
- h) Operational Risk

2.a SF credit risk (including risk multipliers and credit enhancement)

The FHFA proposes a loan level credit risk charge (“CRC” henceforth), with various adjusters for loan characteristics, with additional adjusters for credit enhancements (generally mortgage insurance), and we will address credit risk transfer (CRT) programs separately. We will also endeavor to specifically answer questions in the NPR. Specific comments follow. Virtually all of the comments under 2.a and 2.b can be considered responses to Question 3 and Question 6 of the NPR.

Table 9 (pg. 33338)

The table shows proposed CRC charges for SF loan categories by original LTV (OLTV) and original credit score for new originations (the two dimensions of most similar loan tables). As a base case, we consider an average mortgage, an OLTV between 75% and 80% and credit score between 720 and 740. The indicated CRC is 222 bps, or 2.22% of the UPB. This seems like an unremarkable amount of risk capital for a new loan with decent characteristics—not unusually high or low. Higher OLTV/credit score loans are given sharply higher capital charges—as much as 8% or more for high OLTV/low credit score loans. What concerns us is how low the capital charge—CRC—becomes on low LTV/high-score loans. A brand new mortgage with an OLTV of 70-75% and credit score of ≥ 780 is assigned a CRC of 87 basis points. Is there really such low risk in this loan? This is much less than the lowest minimum leverage capital requirements previously employed by the Enterprises (at the direction of their regulators). OLTV loans $\leq 30\%$ are assigned 10 bps, one tenth of 1 percent. We recognize as much as anyone that large down-payments are strong credit candidates, but this table comes close to saying there is no

³ “Implications of the New Fannie Mae and Freddie Mac Risk-based Capital Standard” Stiglitz, Orzag, and Orzag, Fannie Mae Papers Volume 1, Issue 2, March 2002.

credit risk in such loans. (Note that we understand that Table 9 has numerous secondary credit risk characteristics, as you describe on page 33339. We will address those adjustors in a later section.)

Table 10 (pg. 33340)

Similar to Table 9, the table shows a grid of CRCs for varying types of “seasoned” loans where the CRC is based on “Mark-to-Market” Loan to Value Ratios (MTMLTVs) and “refreshed” credit scores, e.g., credit scores post origination. Again, the reference loan we will look at as an average mortgage has a MTMLTV between 75% and 80% and refreshed credit score between 720 and 740. The CRC for such a loan is 245 basis points, 2.45% of UPB. One major concern of ours is the CRC drops rapidly as MTMLTV does and as the refreshed credit score rises. Most of the lower right portion of the grid has CRCs of less than 200 bps (2% of UPB). We compared this to, for example, Fannie Mae’s recent reporting on its portfolio characteristics. Fifty-two percent of Fannie Mae’s outstanding guaranty book of business as of 12/31/2017 has MTMLTVs less than or equal to 60%.⁴ Unless these low MTMLTV loans have very poor refreshed credit scores, they will prospectively carry RBC capital charges of considerably less than 200 bps, in many cases less than 100 bps. Should “risk-based” capital apply charges on mortgages resulting in capital coverage that is vastly lower than even the historically inadequate minimum leverage ratios? One hundred (100) bps would appear much too low for a substantial portion of either Enterprise’s SF book, for which, in effect, this table allows. This weakness is a major area of concern, as it would allow the RBC charge to be lower than even the leverage ratio percentage for most of the portfolio.

In Question 3, FHFA solicits comments on the use of OLTV, MTMLTV and refreshed credit scores, and whether these introduce pro-cyclical changes in capital availability. As an organization of bankers, we would likely agree that using refreshed estimates of equity and creditworthiness may offer some insight into particular loans, perhaps for evaluations for sale or cross-selling, but used systematically in a regulatory model using this updating of credit characteristics can, and probably will, cause swings in capital charges. MTMLTVs are, of course, model- or machine-based and, as we know, markets and house prices (and estimates) can swing widely and rapidly. An 80% OLTV loan can become a less-than-60% MTMLTV loan and then swing back to being a 90% MTMLTV loan in the space of five years. Based on the tables proposed, capital charges could go down by 50% and then up by 100%. This does indeed sound like it would be pro-cyclical and something to be avoided. We appreciate the FHFA’s interest in our views.

Similarly, refreshed credit scores can provide some useful information about the borrower(s), but offer no insight into the current income or current non-mortgage indebtedness of the mortgagor. Using OLTV and the original credit score are likely the most prudent initial course for credit modeling purposes. Once a loan has aged significantly—we would recommend not less than 24 months—the introduction of MTMLTV may be appropriate. In the guidelines described in the

⁴ Fannie Mae 10-K filing for 2017, page 85.

NPR, a loan is considered “seasoned” after five months. This simply is too short a seasoning window. A loan that defaults within its first three-month payments is called an “early payment default” or EPD. It is a leap to say that a loan is “seasoned” two months later. While there may be some changes to the credit characteristics of a loan after half-a-year’s time, a five or six month only is simply not seasoned enough to draw any inferences about changes in the collateral value (changes in MTMLTV) or changes in the borrower’s credit character.

As a more general point, and addressing Question 7 regarding using separate tables for new and “seasoned” single family loans, we broadly suggest the NPR proposes a too generous interpretation of what seasoning or aging of loans is, and thus when things like MTMLTVs, refreshed credit scores, and in the case of multifamily mortgages, “MTM” debt-service coverage ratios are all used simultaneously, this may have a cumulative effect to pushing the CRC too low. Additionally, the risk multipliers for both SF and MF capital charges provide additional discounting of CRCs for loan aging. The time horizon for when post-origination LTVs, credit scores, DSCR, etc. should be reset using “MTM” values and applied to the CRC should be much longer than the five months FHFA is typically considering, perhaps two to three years from loan acquisition.

Tables 11, 12 - Re-Performing and Re-Performing Modified Mortgage CRC

These tables show the loan level CRCs for unmodified and modified loans with some delinquency history. There is quite a range of capital charges against loans in these grids. For example, loans with between 12 and 36 months since last delinquency can range in CRC from in excess of 10% of the loan UPB down to 6 bps for very low MTMLTV loans. It is obvious that the CRCs in the table are largely driven by MTMLTV. On Table 12, where the CRC is assessed for modified loans, there appear to be very sharp and arbitrary drops in CRC. There is a “cliff” effect from one cell to the next: when a loan goes from being over 36 months since its modification date and 48 months since its last delinquency does it really drop in riskiness by 20 or 30%? We appreciate there is some improvement (reduction in expected loss) but the steps downs in CRC seem too large and this may likely be exacerbated when other multipliers are allowed.

The Tables 9–12 increasingly show seemingly arbitrary drops in CRC based on the criteria chosen. FHFA has not clearly indicated where the data came from and how closely it actually comports with loan performance of the Enterprises (or whether the data have been audited). Great reliance is being placed on these data that make up the CRC grids, and the drops (gradations of CRC) between risk dimensions (MTMLTV, credit score, etc.) can be relatively large. Again, these capital charges will, or may, ultimately influence loan pricing and credit availability in the primary and secondary mortgage markets and may ultimately expose the Enterprises and the U.S. taxpayers to considerable risk as well. We appreciate the FHFA’s position in relying on the Enterprises’ data, but the clear visibility for the public and the lending and investment community will contribute to better understanding of the robustness of the data sources behind the CRC weights. The data has not been closely examined outside of the FHFA and Enterprises, so we urge caution in hastily applying this methodology.

Table 13 SF Non-Performing Loan Base Credit Model

The basic capital charge for non-performing loans appears reasonable, except, once again, it appears to be so heavily driven by MTMLTV, particularly at low (<60%) MTMLTVs, which may make the entire table less reliable than desirable. The loans are nonperforming. There is a reason the borrower did not pay. We recognize that equity in the collateral offers a margin for recovery in a foreclosure or short sale, but the extent of the drop of CBC across the MTMLTV dimension seems questionable.

Table 14 Single Family Multipliers

The table showing proposed “single family risk-multipliers” on pages 33346 and 33347 is based on what would be a reasonable notion, that a layering of credit risks, like those witnessed prior to the 2007 mortgage crisis, apply higher capital requirements to loans with multiple layered risk. Some of these multipliers, the ones that we express the most concern with, are where the multiplier is less than one (1), meaning the capital charge (CRC) is reduced from its base case.

The multiplier for 15-year and 20-year fixed-rate mortgages, FRM, is particularly concerning. The multiplier is 0.3 for FRM 15 and 0.6 for FRM 20, meaning these loans are only charged 30% and 60% of base case CRC. This is a situation where the Enterprises and their regulator may be introducing great distortion into the market.

Fifteen- and 20-year FRMs have lower mortgage rates because their shorter terms and durations reduce risk. Lenders in the primary mortgage market recognize this with lower rates charged on 15s and 20s. These multipliers would seem to compound a benefit to FRM 15s and 20s because of a credit score model. This may be an additive effect that distorts pricing because Fannie and Freddie will have to hold negligible capital against them. We recommend further review to avoid this potential outcome.

We have other concerns about multipliers less than one (1.0). “Loan age” multipliers raise questions, particularly if you are using things like MTMLTV simultaneously. “DTI <=25%” also yields a discount on the mortgage’s CRC. Does a DTI of, say, 24% at the time the loan was originated sufficiently distinguish that mortgagor from one that had a DTI of 26%, particularly if, for example, both loans are five years old? The DTI tells us nothing about the borrower’s current creditworthiness. Again, we want visibility to the public about where the data came from in constructing these tables and how robust the statistical testing was.

More general comments apply to any multipliers less than one (1.0) for: refreshed credit scores for RPLs; payment change from modification (Is it economically perverse to give a troubled borrower a break on their payment when the CRC in that loan is reduced?) (Is it reasonable to have a Table 12 for modified RPLs if the model turns around and haircuts the CRC so that the modified loans basically have the same CRC treatment as those re-performing loans referenced on Table 11?); and, lastly, refreshed credit scores for NPLs (If a loan is classified as an NPL

there is a loss forecasting process for addressing that factor.). Risk-based capital is for unexpected losses. The fact that the mortgagor has a high refreshed LTV should not matter; the loan is either non-performing or it is not. A refreshed credit score may be useful in considering a loan for modification but seemingly not for allocating loss capital to NPLs in an RBC context.

As a last comment on the SF CRCs, the multipliers can be applied multiple times. A mortgage with a high LTV and relatively poor credit score could have the same or lower CRC if the loan happens to fall into one or more advantageous categories. Suppose a seasoned loan with an 80%-85% MTV and refreshed credit score of 700-720 would have a CRC 344 bps in a base case. If that same loan happened to be a FRM 20 with a DTI $\leq 25\%$ and was more than 60-months old, the capital charge would be $344 \times 0.8 \times 0.6 \times .75 = 124$ bps, which is lower than a recent vintage (not new) loan with much lower LTV and higher credit score. The over-application of multipliers results in a loan with only 124 basis points of risk capital, lower than the minimum leverage ratio in past failed capital regimes for on-balance sheet assets and also what we believe to be the inadequate minimum leverage on “Trust” business in the current 2.5% and Bifurcated proposals.

We suggest that no adjusters less than 1 (100 percent of base case) be applied. The structures of tables 9-13 are already generous in reducing capital for good LTVs and credit. There should probably also be limits on the number of multipliers that can be applied to a single cell of the reference grids (Tables 9-12). The use of multiple adjusters, either down or up appears to be over-engineered. Even troubled loans should not be hit multiple times with capital charges. In some cases, mortgages could have CRCs above 15% of UPB if enough multipliers are applied. The application of these multipliers, however well-intentioned, can produce what are perverse results. Some multipliers, *judged on their stand-alone merits*, seem like a good idea, but taken together may produce results that are unsuitable for a portfolio RBC methodology. The public and lending community should be given much more information on how these adjusters will interact and what the actual (adjusted) CRCs would be on some segments of the Enterprises SF books. Until then, we suggest that the methodology is not ready for use.

2.b SF Credit Enhancement and Counterparty Risk

Tables 15–19 of the NPR show various multipliers (discounts, generally) applied to the CRC for loans that have private mortgage insurance. Table 15 shows multipliers where mortgages have non-cancellable MI. One particularly glaring discount is the set of discounts for deep coverage (MI on 25% to 35% of the first dollars of UPB). The discounts are as much as 81% of the CRC. Is there really no possibility that the Enterprises could lose principal and interest on such loans? We realize the weights are averages, but when you create a system, as FHFA is proposing, where some resultant capital charges are so low, you should consider the possibility that you are incenting capital flows to certain businesses and product types. If that is a policy intention, that should be stated explicitly. The CE multipliers shown in Tables 16–19 do not appear unreasonable, other than the extreme haircut on CRC given to deep coverage MI.

The final point of consideration on MI credit enhancement is the counterparty risk to the Enterprises of MI companies, which is a significant risk that the Office of the Inspector General of FHFA noted recently.⁵ As the OIG points out, three MI companies provide two-thirds of the Enterprises' credit enhancement. The NPR discusses evaluation of counterparties and shows a ratings table (Table 20) upon which the Enterprises will create a "CP Haircut Multiplier" which is in practice "gross-up" of the net CRC for MI enhanced mortgages.⁶ The approach seems reasonable; our concern is the transparency of the process where MI companies will be rated as "exceptionally strong financially" versus weak. (There is a 1 to 8 scale) Additionally, Table 22 splits the haircuts into two groups, those from MI companies that have "High" mortgage industry concentration risk and those that have "Not High" mortgage concentration risk. It is our understanding that all the MI companies are monoline insurers concentrated in mortgages, and from our reading, the FHFA OIG is under the same impression. Is the "High" "Not High" concentration really a distinction? This is yet another level of complexity and opacity that is created by the proposed regime. The actual "CP Haircut" charges shown on Table 22 seem reasonable. They offset some of the very low capital charges applied to certain loan types as a result of the CE (MI company) enhancements, but it is a substantial offset only in the case where the MI company is judged to be in a weak financial position. We would really like to have fuller visibility of how this CE and CP Haircut will work simultaneously, and what the contributions are before further consideration. It is our impression that the "Net Credit Risk" shown in dollars on Table 5 of the NPR is already net of the effects CE and the CE adjusters (CP Haircuts) described here. How much, in dollars, is that net effect? The reader of the NPR is presented with a dollar amount of RBC capital relief for CRT programs in Table 5 but not for mortgage insurance. It is very difficult for anyone to fully comment on your proposal without having some bases for comparison to the Enterprises' financial statements at a reference point in time and in comparison to the other RBC components where you do provide dollar estimates.

2.c Multifamily credit risk

The NPR proposes CRC grids for various multifamily (MF) mortgage products. Similarly to SF mortgages, the MF grids have a base level of CRC driven by LTV on one axis and DCSR (debt-service coverage ratio) on the other. Even in the base case, the Enterprises are permitted to use MTMLTV (ordinarily based on a professional appraisal) and MTMDSCR (post acquisition of the loan). Tables 26 and 27 present the MF loan base case for FRM and ARM loans, respectively. Our comments in this section constitute our responses to the NPR's questions 15 through 18.

This CRC treatment of MF loans described in Tables 26 to 28 may be an invitation to gaming the system by allowing latitude in changing LTVs and DCSR post acquisition. Among the troubling issues are:

MTMLTV—as per the NPR, a MF mortgage can be considered "seasoned" after five months, and a post-origination change of a MTMLTV is an option. We believe this is too soon. It would

⁵ FHFA OIG, "Enterprise Counterparties: Mortgage Insurers" February 16, 2018.

⁶ It will be applied as described on page 33356, $\text{Net CRC} = \text{Gross CRC} * (1 - (1 - \text{CE Multiplier}) * (1 - \text{CP Haircut Multiplier}))$.

be remarkable for multifamily properties (the collateral) to be reappraised after, say, six months, and have the servicer or Enterprise establish a new MTMLTV. Guidance in 1240 of the NPR suggests use of an “MF property value index” or recalculating the value based on a review of the property’s NOI and appropriate capitalization rates. The guidance gives the Enterprise(s) or their servicers too much flexibility to lower the MTMLTV. This in turn may sharply lower the required risk capital (CRS). We would suggest that the numerator of LTV’s on income-producing multifamily real estate loans greater than \$1 million of original balance only be changed due to principal pay-down or loan balance modification during the loan’s first 36 months from origination, and after 36 months can only be modified based on a professional appraisal (the denominator cannot be modified for the first 36 months). If these are model-driven MTMLTVs, data about the models should be widely examined by the public and lending community before any decisions about using MTMLTVs on multimillion dollar real estate properties is considered.

MTMDSCR—again, establishing debt service coverage in the real world requires re-underwriting the property, examining the lease income and operating expenses. Who does this and what level of financial and risk controls exist around establishing MTMDSCRs should be a particular concern to FHFA. Guidance in Section 1240 suggests DSCRs can be marked-to-market based on recent operating statements. This is vague guidance and potentially given to abuse. We are not questioning any particular parties’ motives but when examining multimillion dollar mortgages on large properties, market participants in the real world go through extensive, and expensive, due diligence of such assets. We would suggest that no use of MTMDSCR be permitted at all and that the project’s original DSCR be used in the CRC grids.

FRM vs. ARM—in comparing the base case CRC for comparable buckets of MF loans, the CRC for a 1.35–1.5 DSCR by 55–65% LTV loan is 428 basis points, while the CRC for a comparable ARM is 630 basis points, 201 bps (2% of UPB) higher. Is this based upon real experience or is it based upon some preference for FRMs versus ARMs? The FHFA should provide the public and the lending community with data that supports these CRCs. There is a compelling public interest in showing how robust these estimates are or whether they are artifacts of some types of adverse loan selection or other layering of risks that should be examined.

MF risk multipliers—Table 28 shows risk multipliers for MF. Of primary concern are reductions (haircuts) in CRCs for the original/remaining loan term and original amortization term. These multipliers are less than 1. Again, several multipliers would apply to various loan types and, in combination with the proposed ability to use MTMLTV and MTMDSCR, could likely result in loans that have insufficient amounts of risk capital.

As to MF loan size multipliers, the rationale FHFA and by implication the Enterprises give for application of multipliers less than 1 (basically a haircut on the CRC) may be based on assumptions about investors in small versus large projects. Are the haircuts (0.8 and 0.7 multipliers) proposed for MF loans with balances greater than \$10 million and \$25 million based on anecdotal observation or is there some loss history for these segments that supports the proposed treatment? The effect of these proposed multiplier lightens the credit risk load of larger loans in the Enterprises’ MF portfolios. We suggest a multiplier less than 1 be further

scrutinized and analyzed, especially when it is applied to: loan terms, amortization terms, loan size, and special products as described on Table 28.

The comments that FHFA provides in the NPR related to MF risk adjustors indicate that the adjustors may be somewhat *ad hoc*. We offer examples of such language, with italics added for emphasis. Page 33369 states that “IO loans are *generally considered riskier* than non-IO loans”, while page 33370 provides a rationale for a 0.6 adjuster (decrease in CRC weight) for government-subsidized projects because “Less volatile income *broadly translates to lower risk*, and as a result, government subsidized whole loans and guarantees would be assigned a risk multiplier lower than 1.0.” Language such as this indicates that some of the MF risk-adjustments for CRC may not be based on any empirical evidence, but rather some general perceptions at the Enterprises or FHFA. Either government-subsidized MF mortgage loans are demonstrably 40% less risky than comparable unsubsidized MF mortgages or not. It is perhaps ill-advised to simply assume that certain loans are that much less risky. Without more rigorous support, such treatment may unintentionally drive the Enterprises’ loan acquisition towards certain products (government-subsidized MF) versus others.

The NPR does provide a risk-multiplier floor level of CRC at 0.5, meaning that no loan type can be reduced below 50% of the base case CRC charge. This is an admirable and prudential step, although the floor seems low. However, there can be clusters of loans on the Enterprises’ books of business that carry only half the capital charge compared to the base case, and the base case charges can be quite low, particularly if the MTMLTV and MTMDSCR are low and high enough respectively. There might be fixed-rate MF whole loans with a 50 bps risk-based capital charge. Granted, this is the most extreme case, but the mere possibility that the RBC regime would allow this outcome is cause for concern regarding the safety and soundness regime of the Enterprises. Tables 30 and 31 illustrate the net effect of applying all of the various multipliers and grids to the Enterprises’ entire MF book of business. *On a \$499.6 billion UPB exposure of MF, the capital requirement is \$16.5 billion, or 336 basis points (this is before CRT reductions)*. Thus, the risk capital on multifamily credit risk is 3.36% of exposure, a level far less than would be considered prudent for MF assets held by a bank or thrift. The rationale for the outcome of this RBC exercise on the MF book is not clearly justified.

2.d Market Risk

We address all issues related to market risk and interest rate risk here. The NPR states that the Enterprises “closely hedge interest rate risk at the portfolio level through the use of callable debt and derivatives.”⁷ We would caution about being too comfortable with the Enterprises’ ability to hedge portfolio risk. Use of callable debt is typically beneficial only in falling interest rate environments or to manage prepayments on mortgages. The United States generally has been in an interest rate bull market since the 1980s and the Enterprises have scarcely had to deal with a sharply rising interest rate environment. The use of derivative instruments is the Enterprises’ primary tool for managing on-balance sheet portfolio risk from rising rates.

⁷ Pg. 33331 of NPR.

As noted in the respective 10-K filings of the Enterprises, the interest rate stress tests are only for 50, 100 bps rate shocks, and a 25 bps yield curve “steepener.” This is not an especially adverse shock scenario. More adverse stress testing might reveal a need for IRR capital. Bankers, particularly larger banks or banks that follow international guidance,⁸ are directed to use a variety of testing with rate shocks of 200, 300, and 400 bps in various configurations. We realize, of course, that the Enterprises do not have bank charters, but they hold bank-like assets on balance sheet and their ability to rely on debenture sales to fund liabilities is not assured. In designing a RBC system, it seems as if this important component of capital allocation is lacking in the proposal.

We suggest the FHFA not take it for granted that the funding risk (funding of assets using liabilities at a somewhat matched tenor and cost of funds) has been eliminated at the Enterprises. Fannie Mae’s severe problem in 1979–1982 may not be a historical anomaly. The NPR itself states that “both companies issue unsecured debt to fund their retained portfolios holdings, and this debt exposes the companies to funding risk for retained portfolio assets.”⁹

The market risk capital components of RBC described in the NPR focus largely on spread risk (spread shock times spread duration) applied largely on the asset side (SF and MF). It is not clear how the FHFA would treat the risk of spread widening on the balance sheet liability side. The proposed spread risks on the asset side (15 bps) are only a slight widening of yields-to-benchmarks on the retained assets. We do not have visibility to the spread duration that the Enterprises would then apply to calculate the losses resultant from spread widening; the FHFA will rely on the Enterprises’ internal models. Interestingly, as per Question 25 in the NPR, the FHFA proposes that market risk of MF MBS of the “other” enterprise and Ginnie Mae MF MBS be evaluated with a 100 bps spread widening (shock), which is considerably larger than the NPR suggests for own balance sheet treatment of mortgage products. We would concur that spread widening of this magnitude is probably necessary to accurately measure the risks posed by many products held on the Enterprises’ balance sheets, although without knowing the spread durations that will then be applied, it is difficult to gauge the risk-based capital implication.

Both the assets and liabilities of the Enterprises are subject to spread widening. While the Enterprises are in conservatorship, it is unlikely that their costs of borrowing will widen appreciably to benchmark rates, but a RBC model should be designed for outcomes including cases where the Enterprises have to raise money (issue debt) based on their own free-standing creditworthiness, and it is not hard to imagine their spreads to benchmark could widen considerably.

Broadly speaking, we suggest 1) more vigorous testing of spread widening (widening greater than 15 bps, perhaps as wide as 100 bps) and some publicly available information on the spread durations (the change in values) that would be used in assessing the loss, and 2) implementation of testing of the firm’s funding risk using a more bank-like shock testing as described above.

⁸ “Interest Rate Risk in the Banking Book”, Basel Committee on Bank Supervision, April 2016.

⁹ NPR page 33385.

Lastly, the Enterprises are very large participants in the markets for interest rate swaps and swaptions and, in an adverse market (generally up moves in interest rates), the Enterprises will rely upon performance of derivatives (cash inflow to the Enterprises) to mitigate market losses. While the Enterprises use central clearinghouses for many of their derivatives, they still have substantial net exposure directly facing OTC counterparties, and the counterparty credit risk of these exposures should be examined and quantified to include in any final RBC regime. It has been many years since U.S. financial markets experienced a sharp upward move in interest rates or a sharp and sustained divergence between benchmark and mortgage-related assets, but any comprehensive treatment of market risk should address holding capital against large adverse market moves. The current proposal does not sufficiently address unexpected market risk.

2.e Other Assets and Guarantees

In these comments, we address a variety of capital treatment issues for: Enterprise and Ginnie-Mae MF MBS; Private-label MBS; the capital requirement for multifamily commercial mortgage-backed securities (CMBS) held by the Enterprises that are not guaranteed by an Enterprise or by Ginnie Mae; private label MBS; reverse mortgages, municipal debt; cash and cash equivalents.

As a general matter, most non-cash assets should bear some capital charge. Ginnie Mae and other Enterprise MF MBS, as well as REMICs issued by Ginnie Mae and the other Enterprise, pose counterparty and interest rate risk to the Enterprise that holds them. We would suggest some minimum CRC to cover counterparty and market risk, perhaps 50 bps applied to Ginnie and other Enterprise MF MBS, and 100 basis points CRC to any REMIC issued by Ginnie Mae and or the other Enterprise.

For CMBS “held by the Enterprise that are not guaranteed by an Enterprise or by Ginnie Mae,” the NPR suggests a 200 bps charge covering both market and credit risk. We note that the risk charge should ultimately depend on how low in the credit stack (how subordinate) the CMBS position was. We would suggest, absent further information, a higher charge for any CMBS that was not the most senior class of security in a multiclass security, and perhaps a somewhat higher CRC for the “super senior” or analogous classes.

For RBC on “private-label” MBS, we note that Table 25 shows a treatment for these securities, but does not describe the actual securities. Table 25 suggests that \$14.4 billion of private-label MBS be given a capital requirement of \$3.4 billion, for a CRC percentage of 2336 basis points (23.36%), covering credit, market, and other risks. Other things being equal, this is surprising, but these are legacy assets and perhaps are in very subordinate positions or were in securities backed by very poor mortgage assets. FHFA must have its reasons for this position regarding these particular securities, but as a general rule we do not believe FHFA should take a position that SF private-label MBS require excessively more CRC than do agency MBS. Some private-label SF MBS with structure and credit enhancement trade at competitive spreads to SF Enterprise securities and should be evaluated accordingly, not based on some adverse selection of the Enterprises’ legacy assets.

We have no comments on the proposed treatment of municipal bonds and reverse mortgages other than to say we disagree with the statement that municipal debt has no default risk. Many municipal bonds are in fact revenue bonds, often backed by multifamily real estate project's cash flows. The NPR proposes a 760 basis point "market risk capital charge" on municipal bonds, plus operational risk and a going concern buffer. The high levels of risk capital are apparently based on the Enterprises' internal risk models. The fact that these capital charges are so relatively large does, we believe, reflect the underlying credit risk of many of these bonds. Often spread premiums themselves fully reflect credit risk. The risk capital charge for reverse mortgage products seems reasonable to us given the illiquidity and high spread premiums of these products.

Lastly, regarding cash and cash equivalents, cash should bear no risk capital. Cash equivalents are a relative term. It is our view that only U.S. Treasury securities of maturities less than one year, deposits in U.S.-based banking institutions, and short-term deposits at Federal Home Loan Banks or Federal Reserve Banks should qualify for zero-risk-based capital. Any other cash equivalent should have a *de minimis* 50 bps charge. We also suggest that the Enterprises be encouraged to hold some minimum amounts of liquidity, particularly if they transition away from being able to borrow from the U.S. Treasury.

We agree that the appropriate capital treatment of DTAs is to neutralize them as is done in the NPR. We will not weigh in now as to what is your proposed prospective treatment for capital purposes; it is premature, almost pointless, to do this when the Enterprises have little prospect of utilizing the DTA. We certainly want to address the topic in the future and would like every opportunity to do so.

2.f Going-Concern Buffer

The NPR proposes a going concern buffer of 75 basis points of all credit risk assets and 75 basis points of the market value of assets with market risk. It is not clear what the distinction between the two classes is since many assets carry both types of risk but we interpret the results to mean that guaranty business ("Trust") assets are charged 75 basis points of UPB and balance sheet assets are charged 75 basis points of UPB or market value, whichever is lower.

The resultant total charge, as shown in Table 5, is a combined capital requirement of \$39.9 billion for going-concern capital. We think this is a prudential move, especially given our expressed concerns that the proposed credit risk capital charges (CRCs) produce too low a capital requirement and the permitted CRTs reduce that capital even further.

Question 39 asks about the advantages and disadvantages of adjusting risk-based capital requirements by order during periods of heightened risk. If the FHFA needs to adjust RBC, raising the going-concern buffer percentage would be a good tool to use. There are so many interconnected parts of the rest of the model that adjusting other weights (CRCs) or factors would be unwieldy. We believe the resultant RBC level in Table 5—\$180.9 billion, or 3.2% of assets—is low. FHFA has not indicated what it believes an acceptable minimum RBC % to be.

Absent further refinements of the model, and we believe many improvements are possible, we would suggest a more reasonable going-concern buffer be 15 or 20 basis points.

2.g Credit Risk Transfer (CRT) for SF and MF

We reviewed the proposed treatment (and presumably) the calculation of CRT in both the single family and multifamily books of business. We also reviewed the limited disclosures available from the Enterprises on CRT, as well as information from other analysts. Our comments here are both general and specific responses to Questions 9, 10 and 11 in the NPR.

There are three types of CRT that the Enterprises engage in and you apparently use in the proposed RBC regime:

- a) Securitized CRT such as the CAS (Fannie) or STACR (Freddie) securities offerings;
- b) CIRT or similar reinsurance programs where the Enterprises swap portions of g-fee premiums for risk coverage with reinsurers; and
- c) Lender risk sharing, which as fairly straight-forward subordination deals of securitizations where the lender retains a subordinated risk bearing tranche.

The illustrative example of CRT shown on Figure 1 of the NPR¹⁰ could be for a generic example of either a securitized CRT deal or a CIRT reinsurance transfer.

Generically, tranches in the most subordinate positions (“first loss” exposure) earn high amounts of yield (in excess of 10% over LIBOR in many securitized transactions), while the most senior CRT tranches (further from loss) earn a yield typically 100–200 bps over LIBOR.

These CRT transactions are derivatives contracts, in note or certificate form generally, that have limited lives—five, seven, 10 and 12 years, e.g., less than the life of the reference loan pools from which their risk and yields are derived. G-fee income from the reference loans pools is used by the Enterprises to pay the yields to the CRT security holder/reinsurer.

It is our understanding that in the securitized CRT deals the exposure of the senior tranches is diminished, often quickly, as the loans in the reference pool receive scheduled and unscheduled principal (repayment and prepayment). One area of concern or interest on which the FHFA is seeking comment (Question 9) is treatment of prepayment risk on CRT. Securitized CRT started in 2013, so the conditions for CRT development have been in a good economic environment with low default and losses and steady prepayments. It is clear that many purchasers of senior CRT tranches (M-1 tranches, say) may have had their securities paid in full in a couple years and did not absorb any credit risk, or at least any direct credit costs. Thus, there is a danger in some of these structures that the risk transfer benefit to the Enterprises evaporates as portions of the reference pools pay down.

¹⁰ Page 33359 Federal Register

It seems apparent from reading the NPR that the FHFA is heavily dependent on the Enterprises for information about the amounts of risk being transferred, and how much they are paying to the parties “buying” the risk. We examined published information about the CRT programs from the Enterprises and could see little visibility as to exactly how much risk the Enterprises were transferring compared to what they are paying for the risk coverage. Clearly, substantial amounts of the Enterprises’ g-fee income are being passed through to counterparties but it is not obvious how much actual loss (actual loss, not allocated loss) the counterparties are bearing. The earnings of business in a stressed scenario is typically not part of a risk-based capital exercise, but examining the CRT transactions raises questions about whether the Enterprises are simply giving away too much of their g-fee income in order to “transfer” credit risk when in reality the reference pools are quite large and the lives of the pools may far exceed the effective lives (not the contractual lives) of the CRT securities and other policies.

As part of a different analysis, the Congressional Budget Office examined the CRT transactions to assess the impact of CRT securitizations, etc., on federal budget cash flows. We quote them here: “In general, credit-risk transfers may increase the likelihood that the GSEs will need to receive small payments from the Treasury, because interest paid to CRT investors exceeds the value of losses borne by those investors, resulting in lower net income for the GSEs in each quarter.”¹¹ We realize that the CBO’s view is not the definitive word on the subject, but the CBO also raises the possibility that the Enterprises are not receiving value for what they are paying to exchange risk.

In reading the NPR, the Enterprises are supposed to “calculate capital relief” on every CRT. The NPR lays out a logical basis for apportioning “credit risk capital” on the underlying reference whole-loan pools and from there to the associated CRT tranches (typically the CRT vehicles cover about 10%–11% of the reference loan pools). Then the Enterprises are supposed to calculate capital relief accounting for tranche ownership and the terms (loss attachment points) of the tranche, and the CRC of the reference pool of loans. Without delving further into the mechanics of how the “capital relief” is calculated, it is clear that 1) the Enterprises create the CRT structures, 2) the Enterprises sell the CRT structures (in some cases they retain portions of tranches, 3) the Enterprises would pass through portions of g-fee income and *pari passu* principal to some of the tranches and g-fee “interest” to more subordinate tranches, after allocating actual realized losses to the appropriate tranches, and 4) the Enterprises are supposed to calculate how much capital relief they have obtained and also make certain adjustments to these calculations for certain loss timing mismatches between the loan pools, guarantees and terms of coverage on the CRTs. That is the plan.

FHFA is relying on the Enterprises to manage the ongoing development of the program, to execute, and to report the results and effectiveness of CRT. We carefully read and understand the intent of your guidelines, which are intended to make the Enterprise’s reporting useful to the RBC model. From this arises an obvious question. As the Enterprises sell off current and future

¹¹ Congressional Budget Office, “Transferring Credit Risk on Mortgages Guaranteed by Fannie Mae or Freddie Mac” December 2017.

income to reduce risk of losses, how can the taxpayers, the FHFA, or even the Enterprises be sure that they are engaging in an economically sound transaction?

While the general notion of credit risk transfer is appealing, the mechanics of the process, and the accounting for it, do not seem very well locked down. The Enterprises are tasked with reducing SF and MF mortgage credit risk and seem to have made a good start. Absent much more transparency about who is actually calculating the risk capital relief and how effective the CRT is in reducing risk, it is hard to give specific recommendations on, say, Question 9. You describe considering specific triggers in CRT transactions suggesting, for example, breaks in the loss timing factors (shown in the Table 18 of Section 1240) that might act as triggers to mitigate some of the loss timing problems and thus reallocate principal cash flows amongst various tranches. The FHFA wants to avoid mandating limits and triggers, apparently to avoid stifling innovation in these relatively new programs. It seems like the FHFA is asking questions about two separate things: 1) how to make the CRTs work better, and 2) how to measure the CRC reduction of the CRTs in the risk-based capital framework.

Admitted, many financial instruments are bought and sold where the parties do not know prospectively how the cash flows will wind up being distributed in all scenarios. From the language in pages 33359 and 33360, it appears that the FHFA is reluctant to impose mandates on the CRT transactions. The CRTs, as you say, have not been tested in a period of market stress, and the robustness of the CRTs will not be revealed until changing market conditions force losses onto private capital.

If this situation continues unchecked, the Enterprises might simply wind up serving as a financial intermediary that transfers away a substantial amount of g-fee income without actually mitigating enough credit risk. Given the uncertainties about the effectiveness of the CRT, one must be very reluctant to allow calculations of CRT, calculated by the Enterprises, to provide RBC capital relief. RBC measures are supposed to measure, and limit, the risk-taking activities of financial institutions. The scale of relief obtained by the CRT, as well as concerns about how accurately it is measured, lead us to respond to your Question 10, “Should the FHFA consider modifications or alternatives to the proposed rule’s approach providing capital relief for the Enterprises CRT?”¹² Yes, until the CRT has actually been tested in some adverse situations—that is until the CRT actually has to absorb stressed credit losses—its effectiveness is hard to gauge. Whether it works as designed and whether the Enterprises are getting value for their (or the taxpayer’s) money is an unknown. The current situation is akin to relying upon fire-retardant materials in manufacturing when tests may not fully replicate a disaster that might eventually take place.

As is noted on page 33361 of the NPR, “U.S. bank regulators have not given banks capital relief for credit risk transfers as FHFA has proposed to do in this rule for the Enterprises.”

¹² Page 33361

The scale of the relief from CRT is also of particular concern. We will point out some indicators of our concern from your preliminary results:

Tables 23 and 24 show the following related to your calculations for the SF credit book:

SF Net Credit Risk	\$91.2 billion
Less CRT	<u>\$(13.5) billion</u>
Post CRT Credit risk	\$ 77.7 billion

Thus, the CRT is reducing credit risk dollars (losses) by almost 15%. However, we understand that most CRT transactions only effectively transfer about 10% of the risk from a reference pool. Moreover, many SF risk dollars are not eligible for CRT programs (non-performing loans, re-performing loans) so if the base of “SF Net Credit Risk” were smaller—reflecting the SF loans not even eligible as excluded—the amount of Net Credit Risk Capital would be smaller, and the resultant CRT reduction shown above is probably 16-17% of the risk dollars. This seems excessively large.

The outsized risk reduction shown in Tables 23 and 24 can be caused by several factors: FHFA can be underestimating the overall risk dollars in their CRC calculations (our comments so far would suggest we believe that is a possibility) or the Enterprises are overestimating the risk that is being transferred away. There may also be other reasons of which we are not aware.

Regarding the MF book, Tables 30 and 31 show the following

MF Net Credit Risk	\$16.5 billion
Credit Risk Transferred	<u>\$(8.0) billion</u>
Post CRT Credit Risk	\$8.5 billion

In the case of MF, almost 50% of credit risk dollars are assumed transferred away. We realize that the MF CRTs have a different structure than the SF deals, and we appreciate the fact that FHFA is adding a going-concern buffer and other capital charges to post-CRT credit risk capital, but the numbers shown in the NPR reinforce a view that the RBC model underestimates SF and MF CRC (for the variety of reasons we have pointed out). We also understand that the effectiveness of risk transfer is harder to determine in the current economic environment, but that reality is not comforting to policymakers or market participants. We recommend continued scrutiny to the effectiveness of the CRTs at the same time that we support their going development.

2.h Operational Risk

The operational risk charge of eight bps for “all assets” as described in fact relies on the Basel Basic Indicator Approach, which, of course, is a fixed percentage of positive annual gross income averaged over the previous three years.

The calculation shown in Table 5 and the supporting narrative indicates that the \$4.3 billion charge was calculated as 15% of an average of the combined Enterprises’ annual gross net interest income plus net non-interest income averaged over the past three years. We did not attempt to validate the calculation of gross income used in the NPR.

Conclusion

The American Bankers Association appreciates the opportunity to comment on this proposed capital structure for the Enterprises. We believe this is a valuable undertaking both to improve the governance of the Enterprises during their continued conservatorship, and to a limited but important extent, to provide a forum for public discussion and input on the appropriate capital structure and treatment for activities carried out by the Enterprises or their successors in a post-conservatorship environment. It is our hope that our comments constructively add to that discussion. We stand ready to engage with the FHFA, the Department of the Treasury, members of Congress and other policymakers collaboratively to further the shared goals of a well-regulated, appropriately capitalized and equitably available government backing for the secondary mortgage market. If you have questions or comments, or wish to engage in further discussion of our views, please do not hesitate to contact the undersigned.

Best regards,

A handwritten signature in black ink that reads "Robert R. Davis". The signature is written in a cursive style with a large, stylized initial "R".

Robert R. Davis