MORTGAGE BANKERS ASSOCIATION

November 16, 2018

The Honorable Melvin L. Watt
Director
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20219

RE: Enterprise Capital Requirements [RIN: 2590-AA95][1]

Director Watt:

The Mortgage Bankers Association (MBA)[2] thanks the Federal Housing Finance Agency (FHFA) for the opportunity to comment on its proposed rule to implement a new regulatory capital framework for Fannie Mae and Freddie Mac (the Enterprises).[3]

MBA strongly supports the development of revised capital requirements for the Enterprises, which, though suspended while the Enterprises remain in conservatorship, will help facilitate the eventual transition to a reformed secondary mortgage market. The publication of a new capital framework will also help market participants better evaluate Enterprise decision-making processes while they remain in conservatorship. MBA looks forward to continued engagement with FHFA and the Enterprises as the proposed rule is improved and moves closer to finalization and implementation.

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[1] 83 Fed. Reg. 33312, “Enterprise Capital Requirements,” July 17, 2018. Available at: https://www.federalregister.gov/documents/2018/07/17/2018-14255/enterprise-capital-requirements.

[2] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, DC, the association works to ensure the continued strength of the nation’s residential and commercial real estate markets; to expand homeownership; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,300 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies, and others in the mortgage lending field. For additional information, visit MBA’s website: www.mba.org.

[3] In developing these comments, MBA benefited from the research and advisory services of Federal Financial Analytics, Inc. Any and all policy considerations, observations and recommendations contained within this letter are attributable solely to MBA.

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Executive Summary

Though the Enterprises operated as privately owned institutions for decades prior to their near collapse in 2008, they owe their very existence to public charters bestowed upon them by the U.S. Congress—charters that carry responsibilities to serve critical public policy objectives. Among these objectives are liquidity and support for the secondary mortgage market, as well as promotion of access to mortgage credit throughout the nation.

FHFA very appropriately recognizes that the Enterprises—or any future successors or new entrants—cannot meet their responsibilities if the institutions are not carefully managed and sufficiently protected against the inevitable ups and downs of the credit cycle and other market and operational risks. To this end, a robust capital framework that instills confidence in market participants and encourages prudence on the part of senior management must govern such guarantors.

MBA shares FHFA's goal of ensuring that guarantors promote a stable and liquid secondary mortgage market at all times. As such, we support FHFA's efforts to craft an improved capital framework that corrects the failures of the pre-crisis system and builds on the work of existing regulatory constructs.

Developing a thorough and well-calibrated capital framework is a challenging and complex task. The proposed rule represents a strong step in the right direction. Indeed, many aspects of the proposed rule mirror principles previously embraced by MBA. For example, the use of both risk-based and leverage-based capital requirements, together with regular stress testing, represents a solid foundation for capital regulation. Similarly, the proposed rule appropriately calls for capital buffers that would allow guarantors to withstand shocks similar to the 2008 financial crisis. FHFA also explicitly notes the importance of using the regulatory frameworks under which other large financial institutions operate as guideposts to guard against opportunities for arbitrage.

In order to improve upon the proposed rule, FHFA should consider both substantive and procedural changes to the proposal. In terms of the potential impact of the framework, one particularly concerning feature is the procyclicality of the risk-based capital requirements. The use of mark-to-market loan-to-value (LTV) ratios as currently designed would allow guarantors to release capital during stronger markets, only to then require larger capital buffers in the midst of a downturn.

This procyclicality increases the likelihood that guarantors will be forced to raise additional capital at precisely the time they are least able to do so, triggering regulatory actions that would exacerbate negative market conditions. Instead, FHFA

should establish a stable risk-based capital requirement that more accurately reflects the financial health of the guarantors through the credit cycle.
Another area of potential concern is the varying treatment applied to different credit risk transfer (CRT) structures, which could have differential impacts on the multifamily business lines of the Enterprises or other future guarantors. In their current forms, the two Enterprises' multifamily businesses largely rely on distinct CRT executions. These unique approaches have provided important benefits to the secondary mortgage market, including the ability to attract more diverse sources of private capital. FHFA should ensure that the proposed rule does not systematically favor one execution over another, particularly where credit risk protection is substantially similar across executions.

With respect to the process for communicating the proposed rule to the public and soliciting input from interested stakeholders, there is a clear need for more information from FHFA and the opportunity for additional public input. Despite the length and complexity of the proposed rule, there are numerous areas in which it will not be possible for stakeholders to submit more detailed feedback unless FHFA provides the rationale for certain features or the assumptions underlying certain calculations. FHFA's extension of time was helpful but was not a substitute for the type of iterative processes typically used by financial regulators to develop complex new capital rules. In fact, as can be seen from the structure of our comment letter, we find ourselves with more questions than answers with respect to many aspects of the proposed rule. We would ask that FHFA seriously consider the full set of questions posed when developing additional data and information to release prior to further rounds of notice and comment.

This increased level of transparency of information should extend to the Conservatorship Capital Framework (CCF) as well as the framework developed in the proposed rule. Despite its importance in guiding ongoing business decisions at the Enterprises, the CCF has not been made available to the public, nor is there any detailed information regarding how it is applied by FHFA. A critical component in understanding the impacts of the proposed rule is the manner in which the new requirements could alter current risk-taking behavior under the existing CCF. Without a more thorough explanation of the CCF, it will be impossible to fully analyze the changes that could be introduced by the proposed rule.

These concerns, combined with the inherent complexity in setting capital standards for large financial institutions, support a case for an iterative process characterized by a back-and-forth interaction between FHFA and interested stakeholders. *A multi-round set of notice-and-comment periods would give FHFA the opportunity to fine-tune the proposed rule, benefiting from outside points of view, improving it in stages*. Such a process would also allow stakeholders to submit more useful input and

analysis, provided FHFA releases further details with respect to critical inputs and assumptions.

Finally, MBA supports FHFA's intention to continue the suspension of the Enterprises' capital requirements during conservatorship, even once a final rule is adopted. The financial backing currently provided to the Enterprises by the U.S. Treasury extends well beyond what would be needed in a severe recession, negating the short-term need for capital raises. More importantly, the structural weaknesses of the Enterprises that contributed to the 2008 financial crisis must be addressed before the Enterprises are permitted to take any steps towards an exit from conservatorship. Unless the necessary reforms are put into place, the Enterprises (or future guarantors) will not be able to meet the obligations that underpin the very reasons they were created.

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The Need for Robust Capital at the Enterprises

The near-collapse of the Enterprises during the 2008 financial crisis, which necessitated injections of taxpayer funds, revealed structural weaknesses related to their business activities, risk management, regulation and supervision. Perhaps no structural weakness was starker, though, than the inadequacy of the Enterprises' capital requirements at the time. The resulting thin capital buffers failed to perform their primary purpose of absorbing sufficient losses to allow the Enterprises to continue their operations.

The pre-crisis standards were established in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, which set minimum capital levels at 2.5 percent of total (on-balance-sheet) assets and 0.45 percent of (off-balance-sheet) obligations such as mortgage-backed securities issued and guaranteed by the Enterprises.[4] The legislation also directed the Office of Federal Housing Enterprise Oversight (OFHEO) to develop a risk-based capital rule, which it published in its final form in 2001.[5] These requirements proved to be inadequate during the crisis, as default rates exceeded 12 percent for certain single-family mortgage vintages, with overall loss rates above 4 percent. And while other regulatory capital regimes also provided for insufficient buffers during the 2008 financial crisis, none fell as short or had such a systemic impact as the regime under which the Enterprises operated.

[4] 12 U.S.C. § 4612.

[5] 12 U.S.C. § 4611; 12 CFR Part 1750.

In 2008, Congress passed the Housing and Economic Recovery Act of 2008 (HERA), which established FHFA as the successor to OFHEO and authorized FHFA to develop an entirely new regulatory capital framework for the Enterprises. Shortly after HERA was enacted, however, FHFA placed the Enterprises into conservatorship and suspended their capital requirements. Through the decade that conservatorship has spanned, the regulations implementing the suspended capital requirements continue to reflect the old minimum and risk-based standards established by OFHEO under its pre-HERA authority.

In light of the lack of governing regulatory capital standards in conservatorship, in 2017, FHFA implemented the CCF as a mechanism to "assess adequate capital assumptions for the Enterprises while they operate in conservatorship" and "develop an aligned risk measurement framework to better evaluate each Enterprise's business decisions while they are in conservatorship."[6]

While the Enterprises' paths out of conservatorship remain uncertain, as does the future state of the secondary mortgage market, it is imperative the Enterprises, and any successors or new entrants to the market, be held to more rigorous, transparent capital standards. To the extent there is taxpayer support—explicit or implicit—for any portion of their operations, stronger protection is needed to lower the likelihood of future bailouts. Whether they are publicly backstopped or fully private entities, stronger protection is needed against opportunities for regulatory arbitrage or excessive risk-taking. The U.S. residential housing market is simply too critical to financial stability, economic prosperity, and macroeconomic growth to allow institutions so central to its functioning to be undercapitalized.

To this end, MBA published a proposal in April 2017 that called for a reformed secondary mortgage market featuring well-capitalized guarantors able to withstand a stress event at least as severe as the 2008 financial crisis.[7] In addition to noting that "setting [capital requirements] correctly is vital" to any reform plan, the MBA proposal also argues that financial institutions should hold "similar capital for similar risks, regardless of the charter or business model of the entity holding the risk."[8]

MBA supports FHFA's intention to continue the suspension of the capital requirements, even once adopted, as long as the Enterprises remain in conservatorship. Currently, the Enterprises are subject to the requirements of the Senior Preferred Stock Purchase Agreements (PSPAs), which expressly prohibit capital retention beyond specific thresholds. Further, the combined support from the

[6] 83 Fed. Reg. at 33313.

[7] MBA, "GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market," April 20, 2017. Available at: https://www.mba.org/gsereform.

[8] Id.

U.S. Treasury through the PSPAs stands at over $250 billion, well beyond projected losses even under a severe recession—a key conclusion from the Enterprises' annual stress tests.[9] Finally, it is critical that the structural weaknesses of the Enterprises be fully addressed before the Enterprises are permitted to raise capital and begin the process of exiting conservatorship. Without such reforms, the risks of a suboptimal secondary market, taxpayer subsidies and financial instability remain unacceptably high.

Regulatory Purposes of the Proposed Rule

The proposed rule issued by FHFA is highly complex, not only because of its detailed and technical nature, but also because it has two related but distinct purposes:

- **To establish a starting point** for future capital standards post-conservatorship; and
- **To inform the benchmark** for current Enterprise business decisions in conservatorship.

Currently, the exact context in which FHFA would seek to achieve either of those purposes remains uncertain, in that the nature of the Enterprises and their activities could change as a result of legislative reforms or decisions made by FHFA in its role as conservator.

Purpose 1: Establish a starting point for future capital standards

A stated purpose of the proposed rule is to establish a starting point for regulatory capital standards that would apply to future housing enterprises in an as-yet-undefined post-conservatorship era.[10] FHFA acknowledges that new capital standards, even if adopted as a final rule, would not (directly) apply to the Enterprises while they remain in conservatorship.[11]

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[9] FHFA, "Dodd-Frank Act Stress Test Results – Severely Adverse Scenario," August 7, 2018. Available at: https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2018_DFAST_Severely-Adverse-Scenario.pdf.

[10] See 83 Fed. Reg. at 33313 (The updated capital rule "prepares the Agency to modify the capital standards for future housing finance entities, even if they are significantly different from the Enterprises, upon completion of housing finance reform by Congress and the Administration, instead of starting from the outdated OFHEO rules.").

[11] Id. ("[T]he capital requirements in the rule would need to be suspended after adoption of a final rule because the Enterprises remain in conservatorship and are supported by the Treasury Department through the PSPAs which limit their ability to retain capital ….").

A new starting point for future capital standards is appropriate because, as is discussed above, current capital requirements are based on some combination of authority developed prior to the passage of HERA and the undisclosed specifications of the CCF. As a result, the proposed rule represents the first indication of how FHFA might exercise its expanded regulatory capital authority.[12]

It should not be forgotten that regulatory capital standards exist to achieve public policy objectives. In particular, regulatory capital standards that differ from those that would be demanded by investors or counterparties in the course of their market activities are put in place specifically to further those public policy objectives. Therefore, the best way to assess any regulatory capital standard is to consider its impact on those objectives. Design choices, methodologies, experience-based loss benchmarks, and other considerations are employed to achieve those objectives. Therefore, while details are important, what ultimately matters is impact.

For Enterprise regulatory capital standards, the critical impacts are on the following objectives:

- **Cover unexpected losses.** As FHFA notes, a key objective of the proposed regulatory capital framework is "to establish the necessary minimum capital for the Enterprises to continue operating after a stress event comparable to the recent financial crisis."[13] Where there is a government backstop, regulatory capital standards have the related objective of reducing risk to taxpayers.

- **Support mission.** Continued operation of an entity serves no purpose if the entity cannot also fulfill its public policy objectives. Therefore, another key objective of this regulatory capital standard is to enable the Enterprises (or their successors or new entrants) to reasonably fulfill core functions in the single-family and multifamily mortgage markets.

- **Avoid adverse impacts.** Regulatory capital standards must reasonably balance competing public policy trade-offs. Therefore, regulatory capital standards should seek to accomplish the first two objectives above without costs or adverse impacts (e.g., disrupting liquidity or undermining other public policy objectives) that outweigh the benefits.

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[12] Id. at 33312 ("FHFA believes it is appropriate to update the Agency's standards on Enterprise capital requirements to provide transparency to all stakeholders about FHFA's supervisory view on this topic"); 33313 ("The proposed rule serves to transparently communicate FHFA's views as a financial regulator about capital adequacy for the Enterprises under current statutory language and authorities.").

[13] Id. at 33313.

Below, we raise a number of questions that should form the basis of FHFA's evaluation of the suitability of any proposed capital framework. These questions follow from the three objectives identified above.

Objective 1: Cover unexpected losses

One way to assess the effectiveness of the proposed rule in achieving the first objective is to compare the capital requirements that would result from the proposed rule to the capital requirements under other regulatory capital standards, including answering the following questions:

- How do the resulting capital requirements compare with other regulatory capital standards?

- What is the rationale for any observed differences?

- How would the standards be validated as sufficient to meet their estimated levels of protection at the time they would go into effect in the future?

One could also validate the capital requirements resulting from the proposed rule by conducting analysis of the ability of an Enterprise to absorb losses and continue to adequately perform its mission under various conditions. For example, it would be appropriate to test whether the proposed capital standards would require the Enterprises to hold enough capital to continue operating—including actively providing liquidity—under severely adverse market conditions rather than only enough capital to continue some minimal level of operations. This concept raises the following questions:

- What other approaches have been applied to validate that the resulting capital requirements are sufficient to cover unexpected losses (e.g., stress testing)? What are the assumptions about Enterprise activities during a stress scenario? What are the results?

- For risk-based capital standards, what approaches have been applied to validate that required capital levels are appropriately sensitive to risk, and that the resulting overall capital requirements are reasonable under a broad range of possible Enterprise risk profiles and under a broad range of stress scenarios?

Capital standards are necessarily based on a variety of assumptions, so the validity of the capital requirements will depend, at least in part, on the validity of those assumptions. This concept raises the following questions:

- What are the key assumptions underlying the proposed Enterprise capital standards and what are the strengths and weaknesses of each?

- Under what circumstances might these assumptions no longer be valid?

- Do these assumptions capture all material risks?

- What risks are not addressed and what is the rationale for that decision?

Objective 2: Support mission

An Enterprise capital standard is appropriate only if it enables the Enterprise to fulfill its statutory mission or public policy purposes. Assessment along this dimension raises the following questions:

- What would be the expected impacts on Enterprise decision-making?

- To what extent is this decision-making similar to or different from the status quo?

- How might the incentives inherent in the proposed capital framework change Enterprise business decisions as to pricing, product offerings or other issues?

- How might these decisions affect the ability of the Enterprises to fulfill their statutory missions (e.g., to provide stability in the secondary market for residential mortgages; to promote access to mortgage credit throughout the nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing)?

- What are the projected impacts on each Enterprise?

Objective 3: Avoid adverse impacts

For a capital standard to be appropriate, it must meet its core objectives without causing undue harm to other important public policy objectives. Therefore, any capital standard should also undergo an analysis of possible sources of adverse impacts. This concept raises the following questions:

- What potential adverse impacts have been identified?

- How have these impacts been identified?

- What are the costs and severities of these impacts, and how might they be mitigated?
- What transition plan might be employed?
- What adverse impacts have been determined to be acceptable?
- Would the differences in the treatment of the Enterprises' multifamily executions create incentives to change current practices?
- Are the differences in the treatment of the Enterprises' multifamily executions consistent or inconsistent with market treatment of those offerings?

In addition, because incentives can be a root cause of undue harm, it is critical to identify, assess and address all intended and unintended incentives that a capital standard creates. This concept raises the following questions:

- How does the design of the capital standard create both positive and negative incentives?
- To what extent are these incentives aligned with achievement of the first two objectives above? Is the impact of these incentives properly calibrated to achieve those objectives? If not, how has the mis-calibration of incentives been mitigated? What is the residual adverse impact after mitigation?
- To what extent might any of these incentives encourage behavior that is inconsistent with the first two objectives above? To what extent have perverse incentives been mitigated? What is the residual adverse impact of perverse incentives?

Purpose 2: Inform the benchmark for current Enterprise business decisions

The Enterprises are in conservatorship and are subject to the capital limitations of the PSPAs, so they lack the normal business incentives or objective standards that inform many organizations' decision-making, which in turn might otherwise inform Enterprise pricing and other business decisions (e.g., return on equity and long-term shareholder value).

FHFA has sought to fill that gap by employing the CCF, which FHFA put in place in 2017. The CCF appears to be modeled as an economic capital allocation-type framework that provides a basis for the Enterprises' decision-making and for FHFA as conservator to evaluate those business decisions.

While FHFA has not disclosed the specific details of the CCF, the framework appears to closely resemble the proposed capital standards. As FHFA notes, "The CCF is the foundation for FHFA's proposed capital regulation,"[14] and

> "Publication of this proposed rule will assist with FHFA's administration of the conservatorships of Fannie Mae and Freddie Mac by potentially refining the CCF. As with other proposed rules, the rulemaking provides the public with an opportunity to comment on the proposed capital requirements. As FHFA reviews the public comments and works to finalize the rule, the Agency expects to adopt material and appropriate changes into the existing CCF.[15]
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> [W]hile the Enterprises are in conservatorship, FHFA will expect Fannie Mae and Freddie Mac to use assumptions about capital described in the rule's risk-based capital requirements in making pricing and other business decisions. Feedback on this proposed rule will also inform FHFA's views in evaluating Enterprise business decisions while the Enterprises remain in conservatorship."[16]

It is difficult to comment meaningfully on the proposed rule's relationship to the CCF, as FHFA has not publicly disclosed the details of the CCF, or even identified areas where the CCF is similar to or different from the proposed rule. To provide an opportunity to comment meaningfully, FHFA should develop the answers to the following questions:

- What are the assumptions and other specifications of the current CCF, and how do they compare to those within the proposed rule? What assumptions or elements of the CCF is FHFA considering changing?

- How has FHFA identified, assessed and addressed the incentives created by the CCF? How does the proposed rule mitigate perverse or mis-calibrated incentives? What is the residual adverse impact?

- What have been the experiences of the Enterprises (and FHFA) to date in applying the CCF? For example, is the CCF sufficiently granular to guide Enterprise business decisions? Have there been instances where Enterprise business decisions were permitted to override the CCF?

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[14] Id.

[15] Id.

[16] Id. at 33312.

- To what extent has the current CCF already changed Enterprise business decisions? Was that appropriate?

- Do current Enterprise business decisions (e.g., pricing) reflect the standards embedded within the CCF? If not, why not?

- What governance processes and framework are in place around Enterprise application of the CCF and FHFA oversight of that application? What governance or oversight framework is in place to address Enterprise business decisions that may be inconsistent with the CCF?

- Is the CCF calibrated against a utility model or some other business model?

- How does the CCF consider the obligation to fulfill statutory purposes or the Enterprise charter provisions contemplating accepting lower returns in some cases for actions fulfilling statutory missions?

- For the Enterprises' multifamily business lines, how would possible changes to the CCF result in different Enterprise business decisions around multifamily pricing or offerings? How is the treatment of each Enterprise's multifamily executions under the proposed rule or the CCF consistent or inconsistent with how the market treats these executions?

The Three Prongs of Capital Regulation

At the core of the framework developed in the proposed rule is recognition of three distinct components of capital regulation—risk-based capital, leverage-based minimum capital, and stress tests. MBA views all three as critical and necessary components of a well-calibrated capital framework. Risk-based or minimum capital requirements would set the floor for the Enterprises' capital buffers at any given point in time, while regular stress testing would inform FHFA (and others) as to the adequacy of the Enterprises' capital buffers across varying scenarios.

These three prongs of capital regulation also form the basis for the post-crisis regulatory framework applied to large banks and bank holding companies (together, "banks"). In determining the appropriateness of specific provisions of the proposed rule, FHFA should consider how these provisions align with, or differ from, related provisions with respect to large banks, as well as other large financial institutions. In particular, FHFA should provide more detailed analytics that evaluate the capital treatment of similar assets and exposures across the Enterprises and other institutions. Where there are material differences in business models or other relevant factors that affect the risk associated with that asset or exposure, the Enterprise standards should reflect these differences. Where there are no (or

immaterial) differences, the Enterprise standards should align with those of other institutions to discourage regulatory arbitrage.

Risk-Based Capital

The countercyclical role of the Enterprises

The critical element of the support the Enterprises provide to the mortgage market is their continued presence as a supplier of liquidity through all parts of the credit cycle. In particular, the ability of originators to sell loans to the Enterprises during periods of reduced demand from other sources of private capital protects against widespread disruptions in credit availability for borrowers throughout the country. This countercyclical role is foundational to the existence of the Enterprises.

In order to serve this role effectively, the Enterprises need to be capable of continuing their business activities during a downturn in the housing market or broader financial markets. The capital framework under which they operate should therefore promote this objective.

As is noted in the proposed rule, however, the risk-based capital framework features a procyclical design under which the Enterprises' capital requirements would likely fall during stronger markets. The procyclicality of the risk-based capital framework largely derives from the use of mark-to-market LTV ratios in determining required capital. For example, as home prices appreciate at a faster pace during periods of housing market strength, LTV ratios will fall, thereby lowering the level of capital required to be held by the Enterprises.

And as the proposed rule also notes, "The housing market can be highly cyclical and downturns are often preceded by rapid and unsustainable home price appreciation, resulting in the potential for the Enterprises to release capital ahead of a downturn when their access to the capital markets may be constrained."[17] More simply, if the Enterprises are to play a countercyclical role during a downturn, they need sufficient capital to reliably continue their operations *through the downturn*.

In addition to concerns regarding the solvency of the Enterprises during a downturn, a procyclical risk-based capital framework also raises concerns regarding the gap between actual and required capital during a downturn. As LTVs increase in a period of falling home prices, the loans held or guaranteed by the Enterprises are deemed to be riskier under the risk-based capital framework, thereby increasing the Enterprises' required capital levels. However, such an increase in required capital would come at exactly the time that, as is acknowledged in the proposed rule, the

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[17] Id. at 33379.

Enterprises could be constrained in accessing the capital markets. With required capital levels rising while actual capital levels are falling, the Enterprises would be at significant risk of being classified as less than adequately capitalized by FHFA, potentially triggering regulatory intervention.[18] In such a scenario, it is unlikely that the Enterprises could effectively continue their countercyclical roles. To avoid such an outcome, an Enterprise would need to hold a substantial capital buffer above the required level during healthier markets, which would add substantial costs to the system.

And while the presence of a leverage-based minimum capital requirement would blunt this procyclicality as home prices are increasing, it would only serve to partially offset the Enterprises' ability to release capital if balance sheet positions remain unchanged, and would be even less effective if balance sheet positions grow under benign market conditions. Further, the leverage-based minimum capital requirement could do little to narrow the gap between actual and required risk-based capital during a downturn if asset holdings remain unchanged.

Leverage ratios generally do not constrain risk-based capital procyclicality due to their fixed nature under constant asset holdings, with leverage ratios only exacerbating procyclicality if they serve as the binding capital constraint and encourage risk-taking in ways not captured by regulatory risk weightings. A leverage ratio may serve a countercyclical purpose by setting a floor under risk weightings, but this framework generally does not alter the ability of a firm to engage in new business under stress given ongoing risk-based capital requirements.

Similarly, the proposed rule notes the authority of FHFA to adjust components of the risk-based capital framework to reduce its procyclicality. Discretionary authority on the part of the regulator is preferable to a system that requires adjustments to take place through rulemaking, given the potential time sensitivity of any adjustments in response to rapidly changing market conditions.

However, to provide yet greater certainty that the Enterprises' countercyclical roles will not be jeopardized, the proposed rule should remove its use of LTV ratios that are fully marked to market. Replacing mark-to-market LTV ratios with original LTV ratios carries its own consequences, though. The proposed rule properly notes that using original LTV ratios in the risk-based capital framework would less accurately represent the Enterprises' risk profiles.

To strike an appropriate balance between these considerations, the proposed rule could feature a capital grid with LTV ratios that are adjusted based on fundamental or

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[18] See 12 U.S.C. § 4615-4717 (supervisory actions applicable to undercapitalized, significantly undercapitalized and critically undercapitalized regulated entities).

longer-term changes in home prices. For example, LTV ratios could be marked to market, with upside and downside caps that limit the adjustments from moving beyond certain thresholds in a given year. The proposed rule could also seek to capture equity extraction rather than market fluctuations in home prices in order to protect against unnecessary volatility. While such systems would continue to require thorough monitoring by FHFA, they would provide the benefit of stabilizing Enterprise capital requirements over time.

Open questions:

- Do the benefits of a stable capital requirement outweigh the more precise measurement of risk that mark-to-market LTV ratios provide?
- What are the best methodologies by which to smooth movement in LTV ratios over time?
- Under what scenarios would FHFA likely use its discretionary authority to adjust the risk-based capital framework? How would it communicate these expectations to market participants?

Multifamily considerations

The Enterprises exist to provide stability and liquidity with respect to both single-family *and multifamily* residential mortgages.[19] The Enterprises' roles in multifamily mortgage finance are recognized in their charter language,[20] in specific multifamily reporting requirements imposed by statute on FHFA[21] and in annual housing goals for the Enterprises that by statute must address single-family and multifamily mortgages that they purchase.[22]

To fulfill their mission to increase the liquidity of mortgage investments and improve the distribution of investment capital available for multifamily mortgage financing, each of the Enterprises' respective multifamily businesses has developed distinct multifamily executions.

[19] Fannie Mae charter, 12 U.S.C. § 1716; Freddie Mac charter, 12 U.S.C. § 1451.

[20] See, e.g., 12 U.S.C. § 1723a(m)(2) (mandating the collection and reporting of data relating to Fannie Mae's multifamily housing mortgages).

[21] See, e.g., 12 U.S.C. § 4563 (requiring the director to establish a single annual goal of "purchases by each enterprise of mortgages on multifamily housing that finance dwelling units affordable to low-income families.").

[22] See 12 U.S.C. § 4561(a) (establishing housing goals).

The existence of two primary multifamily executions enhances the Enterprises' ability to fulfill their statutory purposes, individually and collectively. For example, having two different multifamily executions increases liquidity by providing investment vehicles that attract different sources of mortgage capital. Also, because the different executions may perform differently under varying economic circumstances, the diversification effect of multiple executions helps bolster the systemic resilience of multifamily capital markets.

In light of the public policy benefits of having two available Enterprise multifamily programs, particularly while in conservatorship, a risk-based capital rule should not systematically favor one execution over another.

Open questions:

- What would the likely impact of the capital treatment on various multifamily executions be on the current multifamily market?
- Are there ways that the proposed rule could better reflect the differences in credit risk protection offered by various multifamily executions without significantly favoring one type of execution over another?

<u>Single-family credit risk</u>

With respect to the credit risk of single-family mortgages, the proposed rule diverges from the Basel Committee on Banking Supervision (Basel) standardized approach for banks, which applies risk weightings generally ranging from 20 to 70 percent based on LTV ratios. Instead, the proposed rule features "a series of approaches, which include base grids, risk multipliers, assessments of counterparty risk, and capital relief due to credit risk transfer transactions …" which are more akin to the Basel advanced approach. The use of a nuanced, granular approach that accounts for loan-level risks and is more aligned with the Basel advanced approach is reasonable. However, we strongly question the assertion that the look-up tables in the proposed rule are inherently more transparent than internal econometric models, due largely to the discretion afforded in applying look-up tables and the difficulty in comparing standardized and complex risk weightings.

It is unclear how FHFA arrived at the specific capital requirements implied by each of the credit risk factors in the proposed rule, which also appear to vary across differing categories of loans. For example, the primary credit risk factors for single-family whole loans and guarantees (new originations) are original credit score and original LTV ratio. However, secondary credit risk factors include loan size, age, terms, purpose, and origination channel, among many others. The proposed rule features

similar constructs for performing seasoned loans, re-performing loans (modified and non-modified), and non-performing loans.

Presumably, these capital requirements are derived from calculations regarding their impact on probability of default and loss given default. However, greater clarity is necessary for market participants to provide detailed feedback on the appropriateness or validity of these requirements. To further increase transparency, FHFA should provide more information regarding the methodology used to develop these look-up tables, as well as the assumptions on which they rely and the extent to which they allow the Enterprises to vary risk weightings.

The proposed rule accounts for lifetime losses when determining capital requirements due to credit risk, rather than expected losses over some shorter time horizon. This is a well-reasoned choice because, as the proposed rule notes, product features can influence the timing of losses and unexpected losses are also captured under this approach. Further, the relevant time horizon in the proposed rule would better align with the implementation of the Current Expected Credit Losses accounting standard, which also requires upfront estimation and recognition of life-of-loan losses—while raising its own set of issues.

Similarly, the proposed rule includes a cogent rationale for establishing credit risk capital requirements that are meant to cover unexpected losses, with guarantee fees priced for—and loan loss reserves established to cover—expected losses. By setting the threshold for unexpected losses (in the single-family market) as those roughly equivalent to the credit losses experienced during the 2008 financial crisis, the proposed rule establishes a framework for sufficient credit risk protection.

Open questions:

- How would the Enterprise capital required under the proposed rule differ if the risk weights used by U.S. banking regulators were applied?

- How sensitive is the Enterprise capital required under the proposed rule to small changes in the grids and multipliers that are used?

- How reliable are the assumptions underpinning the grids and multipliers that are used?

<u>Single-family credit risk transfer</u>

One of the most significant structural reforms to the Enterprises in their decade of conservatorship has been the development of robust, single-family CRT programs. Since their inception in 2013, these programs have transferred credit risk to a variety

of private sector entities, with a total risk in force of approximately $81 billion.[23] During that period, the Enterprises also transferred approximately $278 billion of risk in force to primary mortgage insurers.[24] And while the extensive use of CRTs is particularly important with the Enterprises explicitly reliant on taxpayer support, there is ample evidence in favor of ongoing CRTs as a permanent part of the Enterprises' business models.

As CRT offerings continue to develop and expand, FHFA should take care to avoid implementing any standards in the proposed rule that improperly advantage certain CRT executions through its modeling choices. With respect to the Enterprises' single-family business lines, CRTs have been conducted through insurance and reinsurance transactions and through capital markets transactions. Both entity-based and market-based CRTs are valuable means of dispersing risk away from the Enterprises, and both structures are likely to perform well during certain parts of the credit cycle while faring less well during other parts of the cycle.

The proposed rule should therefore recognize that overestimating or underestimating the necessary capital requirements for different CRT structures carries implications for the stability of the entire housing finance system. Providing too much capital relief relative to true loss-absorbing capacity could result in an overreliance on certain forms of CRT, which could heighten taxpayer exposure to future losses. For example, if the parameters of the model too harshly penalize CRTs for which the Enterprises' counterparties have concentrated mortgage-related assets (due to correlation risk), there may be too large an incentive for the Enterprises to utilize capital markets transactions. While such an outcome may not be problematic during benign market conditions, a financial market disruption could lead to significantly lower demand in the capital markets. In the absence of strong and vibrant entity-based CRTs, the Enterprises could be exposed to greater risk.

Similarly, if the parameters of the model are punitive in their treatment of capital markets transactions (due to a perceived lack of reliability through the credit cycle), the Enterprises are likely to focus most of their CRT activities on insurance and reinsurance transactions. By doing so, however, the Enterprises would likely develop more substantial exposures to a smaller number of counterparties. If one (or more) of these counterparties were to experience financial stress, either due to market conditions or an idiosyncratic event, the Enterprises could face larger losses.

If, on the other hand, the proposed rule provides insufficient capital relief for CRTs, the Enterprises would likely disperse less credit risk and instead retain more of this

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[23] FHFA, "Credit Risk Transfer Progress Report – Second Quarter 2018," November 1, 2018. Available at: https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Progress-Report-2Q18.pdf.

[24] Id.

risk themselves. A downturn in the mortgage market then would likely have more severe consequences for the financial health of the Enterprises.

To more accurately strike the appropriate balance with respect to the capital treatment of CRTs in general—as well as the relative capital treatments for different CRT structures—over time, FHFA should explicitly require the Enterprises to engage in CRTs at significant levels and through varying structures. Such a requirement could be included in the proposed rule, though it is likely more appropriate that it take the form of a separate rulemaking. Specific mandates could include CRT targets in both the single-family and multifamily business lines, minimum levels of entity- and market-based CRTs, minimum levels of first-loss risk transfer, and ongoing CRT activity throughout the credit cycle. FHFA, in its capacity as regulator, could maintain an ability to alter or reduce CRT requirements based on market conditions, though such exceptions should be reserved for exigent circumstances.

Open questions:

- Are there market conditions under which the proposed rule would significantly encourage or discourage CRTs?
- Are there market conditions under which the proposed rule would significantly encourage or discourage either entity-based or market-based CRTs?
- Is the proposed rule designed to target a particular CRT coverage level? If so, are these targets meant to change through the credit cycle?
- Which standards, if any, that are currently applied to banks engaging in structured risk transfers or CRTs with various mitigation structures would be most appropriate with respect to the Enterprises? Should such standards address operational criteria (documentation, enforceability, irrevocability), credit criteria (collateral), or both?

<u>Multifamily credit risk</u>

Under the proposed rule, the computation of the gross multifamily credit risk requirement involves two elements: the base credit risk capital grids and a set of risk multipliers. Values in the base credit risk capital grids (Tables 20 and 21 to Part 1240) are based on modeling of stress scenarios that assume a net operating income decline of 15 percent and a property value decline of 35 percent, as described below. As described in the proposed rule, this stress scenario is consistent with the following benchmarks:

- Market conditions observed during the 2008 financial crisis;
- Views from third-party market participants and data vendors; and
- Assumptions behind the severely adverse scenario in the stress tests required under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[25]

The risk multipliers take into account debt-service coverage ratio, LTV ratio, payment performance, loan term, interest-only features, loan size, and special products, among others factors. According to the proposed rule, the values of the multifamily risk multipliers are based on:

- FHFA staff analysis and expertise; and
- Enterprise model results and business expertise.[26]

The resulting multifamily credit risk capital requirements are substantially higher than comparable credit risk capital requirements, which would be inconsistent with relative performance during the 2008 financial crisis benchmark.

Credit risk capital requirements	**Multifamily**[27]	**Single-family**[28]
New originations	449 bps	257 bps
Performing seasoned loans	325 bps	138 bps

Those summary descriptions of the relevant benchmarks and sources for inputs into the risk multipliers do not provide the information necessary to fully analyze and provide feedback on the base credit risk capital grids, the underlying stress scenario, the risk multipliers or the resulting multifamily credit capital requirements.

Open questions:

- What are each of the specific benchmarks referred to in the proposed rule and how is the proposed stress scenario "consistent with" each of those benchmarks (i.e., what are the specific comparisons)?

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[25] 83 Fed. Reg. at 33364.

[26] Id. at 33363-64.

[27] Id. at 33375 (Table 31).

[28] Id. at 33362 (Table 24).

- To what extent did FHFA adjust its consideration of each of the identified benchmarks to account for facts and circumstances or structures that may no longer be present?
- What efforts did FHFA take to calibrate the stress scenario to ensure internal consistency in credit risk requirements across single-family and multifamily loans?
- What is the rationale behind each of the risk multipliers, and how did specific analysis, model results or expertise inform the development of the risk multipliers?
- What steps did FHFA take to ensure that reliance on FHFA staff analysis and expertise, as well as Enterprise model results and business expertise, did not result in a narrow range of views (e.g., did FHFA also incorporate non-Enterprise-centric perspectives regarding multifamily mortgage risk)?
- Why does the proposed rule require significantly more credit risk capital on multifamily loans than single-family loans, given their relative credit performance, particularly during the 2008 financial crisis?

Multifamily credit risk transfer

The proposed rule would reduce the amount of credit risk capital required in recognition of the extent to which an Enterprise transfers multifamily mortgage credit risk to a third party by applying a four-step process: (1) distribute risk across tranches; (2) calculate capital relief by tranche; (3) apply haircuts to capital relief for each tranche for counterparty credit risk, where applicable; and (4) calculate net capital relief for each tranche.

The haircuts in Step 3 would be based on a combination of a counterparty rating and a concentration risk assessment. The resulting haircuts would apply to the uncollateralized portion of the relevant tranche, after also partially taking into account the impacts of Enterprise contractual control over the lender's guarantee fee revenue (e.g., the ability of an Enterprise to mitigate losses by taking control of servicing rights).

Because Fannie Mae's Delegated Underwriting and Servicing (DUS) program involves counterparty credit risk and Freddie Mac's K-Deal program does not, Step 3 would apply only to Fannie Mae's DUS program. As a result, accurate and appropriate specifications in Step 3 will be critical to calibrating the proposed capital standard across the two Enterprises as a matter of risk.

Unfortunately, despite the description provided in the proposed rule, the methodology underlying Step 3 is not entirely clear. For example, the proposed rule does not describe in detail the analysis that would underlie the counterparty ratings, or the factual or analytical basis for the particular haircut values. As a result, there is not enough available information to fully analyze and provide feedback on this critical element of the proposal, which warrants additional information and additional opportunity for public input.

Open questions:

- What analysis led to the counterparty financial strength ratings?
- How would FHFA ensure that the analysis would be performed consistently across the two Enterprises?
- What is the factual and analytical basis for the multifamily counterparty risk haircut multipliers by concentration risk?
- How has FHFA ensured that the proposed approach for taking counterparty credit risk associated with CRT structures into account results in appropriate calibration of capital to risk across the two Enterprises' respective multifamily programs?
- What are the results of the application of the proposal to each Enterprise's portfolio and to new originations, and how would those results vary under different market or economic circumstances?

Multifamily supplemental tables

On November 6, FHFA released multifamily supplementary tables in connection with the proposed rule.[29] The tables show estimated risk-based capital requirements for multifamily whole loans, guarantees and related securities as of September 30, 2017, separately for Fannie Mae and Freddie Mac. The tables illustrate that the proposal would result in very different post-CRT net credit risk capital requirements for the two Enterprises' multifamily offerings, as follows:

[29] FHFA, "Proposed Rule on Enterprise Capital – Multifamily Supplementary Tables," November 6, 2018. Available at: https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/S_MF_T_1162018.pdf.

	Fannie Mae	**Freddie Mac**
Net credit risk	$9.1 billion	$7.5 billion
CRT credit	($2.4) billion	($5.6) billion
Post-CRT net credit risk	$6.7 billion	$1.9 billion
Post-CRT net credit risk	251 bps	80 bps

MBA appreciates this additional information. We believe, however, that the proposed rule, even supplemented by these tables, continues to fall short in providing the information necessary to analyze and comment on its likely or possible impacts. In particular, it does not provide the information necessary to fully analyze and comment on the competitive impacts of the proposal.

Open questions:

- How were the values in the table computed?
- How well aligned are those results with market perceptions of the relative risks inherent in the Enterprises' respective multifamily programs?
- How would each Enterprise's capital requirements change under different economic circumstances?
- How might the Enterprises change their business practices under different circumstances as a result of changes in conditions or the proposed rule?
- What is the potential impact of the proposed rule on the long-term viability of either or both approaches to CRT—in particular considering the countercyclical impact of mark-to-market LTVs?

These are fundamental modeling and policy decisions that deserve additional public disclosure and input.

Market risk

The Enterprises' holdings of mortgage-related assets—both whole loans and securitized or structured products—exposes them to market risk. As the proposed rule notes, this risk primarily takes the form of interest rate risk and spread risk, and the Enterprises have historically hedged their interest rate risk in a more comprehensive manner than their spread risk.

While the Enterprises hedge their interest rate risk in accordance with internal controls and risk limits, they remain exposed to risks associated with counterparty failure. It is unclear if the proposed rule recognizes, and requires the Enterprises to

hold capital with respect to, the failure of a hedging counterparty. FHFA should ensure that the Enterprises' capital requirements account for the potential failure of counterparties associated with hedge positions, including interest rate risk hedges.

In determining capital requirements for assets or exposures with more complex market risk, the proposed rule relies on the Enterprises' internal models. The proposed rule goes on to describe the Enterprises' model risk management processes, including the various FHFA supervisory activities to oversee these processes. It is worth noting that similar internal models used by large, complex banks are subject to extensive restrictions, validation, back testing, and control requirements. FHFA should assess any material differences between model risk management and supervision at large, complex banks and the Enterprises to ensure that the Enterprises' modeling with respect to market risk is sufficiently robust.

Open questions:

- How does the proposed rule contemplate the failure of a hedging counterparty?
- How do the Enterprises' model risk management processes, including FHFA supervisory activities to oversee these processes, differ from similar processes at large, complex banks or those required by federal banking regulators? What do these differences imply for the overall confidence in market risk estimates and the associated capital requirements?
- How would the approach to market risk within the proposed risk-based capital framework need to be adjusted or strengthened depending on the business models of post-conservatorship Enterprises or additional guarantors?
- What are the assumptions that led to a higher market risk requirement for multifamily securities relative to multifamily whole loans?

Operational risk

Global financial regulators have long recognized the operational risks associated with events such as infrastructure interruptions, internal control failures, fraud and human errors. The ever-increasing reliance on digital capabilities, and the commensurate growth in potential losses due to cyberattacks, has only sharpened regulators' focus on the need for strong operational risk management and recovery and resiliency standards.

The proposed rule includes an operational risk capital requirement of 8 basis points (relative to the unpaid principal balance or market value of the Enterprises' assets

and guarantees). This requirement is derived from the “Basic Indicator Approach” under the Basel II framework. Here, an explicit connection to operational risk standards used for banks is very reasonable, as many operational failures have little to do with the underlying business in which an institution is engaging, and the Enterprises are therefore subject to similar operational risks as those faced by other large, complex financial institutions.

It is unclear, however, why the proposed rule chooses to utilize the Basic Indicator Approach rather than the Advanced Measurement Approach used by U.S. regulators for banks of a similar scale as the Enterprises. The proposed rule notes that the Basic Indicator Approach “is simple and transparent, and it ensures a consistent treatment across the Enterprises.”[30] Such an approach, however, does not seem to align with the size and complexity of the Enterprises. Further, it is unclear why the proposed rule references the Basel II framework rather than the newer standards in the Basel III framework.

The most effective measures to guard against the potential for significant losses due to operational failures would be enhanced standards for the Enterprises’ resilience, recovery and resolution plans. In the context of a capital framework, FHFA should consider how the proposed 8-basis-point requirement compares with the requirements for large, complex banks under the standards currently imposed by U.S. regulators.

Open questions:

- How would the Enterprise capital required under the proposed rule differ in magnitude relative to the capital that would be required under the Advanced Measurement Approach?

- To what extent have FHFA or the Enterprises attempted to estimate the potential losses from a major operational failure at the Enterprises, including any expected recovery costs? Is the capital required under the proposed rule sufficient to absorb these estimated losses?

<u>Going-concern buffer</u>

As is noted above, the continued operation of an entity serves no purpose if the entity cannot also fulfill its core functions. In the case of the Enterprises, this concept translates into their requirement to provide liquidity to the mortgage market throughout the credit cycle. To help prevent the Enterprises from pulling back from their role as liquidity providers during a period of severe stress, the proposed rule

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[30] 83 Fed. Reg. at 33333.

imposes a going-concern buffer of 75 basis points (relative to the unpaid principal balance or market value of the Enterprises' assets and guarantees). Such a buffer is meant to provide a capital cushion that would allow the Enterprises to continue to purchase loans and play the countercyclical role that market participants and policymakers expect.

Based on the calculation and imposition of the going-concern buffer, it is unclear how it is meant to interact with the leverage-based minimum capital requirements contained in the proposed rule. The going-concern buffer is calculated in proportion to the projected gap between the risk-based and leverage-based capital requirements under a severe stress scenario. This calculation implies that the going-concern buffer may be meant to ensure that risk-based capital does not fall below the leverage-based minimum capital requirement during a downturn, thereby retaining the risk-based standard as the binding constraint. The going-concern buffer, however, appears to exclude certain off-balance-sheet obligations, making it still less clear how exactly it would accomplish this objective.

The going-concern buffer is also described in the proposed rule as a type of minimum capital threshold, which would allow the Enterprises to continue to operate and fund 1-2 years of new acquisitions. If the buffer serves as a minimum capital threshold under a risk-based standard, it is in some ways analogous to the leverage-based minimum capital requirement, though it is unclear what its purpose is in a scenario in which the risk-based standard is not binding. FHFA should therefore clarify the impact the going-concern buffer would have on its desired binding capital constraint in a severe stress scenario.

Open questions:

- How would the size of the going-concern buffer differ if its calculation was based on stress testing results that included a valuation allowance on deferred tax assets?

- Given that the size of the going-concern buffer, as set in the proposed rule, is based on stress testing results, how sensitive is the required buffer to the particular scenario envisioned in the stress test?

- What is the primary objective of the going-concern buffer, and how does it interact with the leverage-based minimum capital requirement?

<u>Unassigned activities</u>

The proposed rule correctly notes that no capital framework can anticipate the specific details of future products, obligations, exposures or activities, and therefore

must instead rely on a *process* by which unassigned activities can be evaluated under the framework at a later date. To address this issue, the proposed rule includes a process by which an Enterprise must notify FHFA of its intent to undertake a new activity and propose an interim capital treatment for that activity. FHFA then in turn analyzes the Enterprise's proposal and determines the appropriate capital treatment, though the Enterprise is allowed to use its proposed capital treatment to prepare its quarterly capital report if it has not yet received an official determination from FHFA.

While this process does, as the proposed rule suggests, strike a balance between rigor and timeliness, it is notable that the process is conducted in a proprietary manner between FHFA and the Enterprise. Such a process is somewhat analogous to the U.S. rules applicable to banks prior to the 2008 financial crisis, but is less aligned with newer approaches such as the more detailed risk management principles for new products established by the Office of the Comptroller of the Currency.[31]

It is also unclear how the process in the proposed rule addresses risks beyond credit risk. New activities may require credit-risk weightings from FHFA, but they also may feature liquidity, interest-rate, settlement, and reputational risks, among others. One relevant example is the provision of liquidity facilities for certain mortgage servicers, which features liquidity risk in addition to credit risk. Were a bank to provide similar facilities, it would face constraints in the form of liquidity requirements. FHFA should therefore ensure that non-credit risks are appropriately captured in its process for evaluating new activities so as to prevent regulatory arbitrage.

FHFA should also remain cognizant of the fact that activities that represent a small portion of an Enterprise's balance sheet or aggregate activities may still be quite large relative to counterparties or other market participants. Past experiences in financial markets have shown that small exposures have the potential to grow rapidly, particularly if an opportunity for regulatory arbitrage creates a competitive advantage. FHFA must take care that its process for evaluating new activities recognizes these potential risks.

More broadly, it is critical that FHFA ensure that new Enterprise activities are not designed or implemented in a manner that supplants private sector activity in the mortgage market. When reviewing proposed new activities, FHFA appropriately undertakes a legal analysis to assess whether the activities violate the terms of the Enterprises' charters. These reviews would also benefit from a careful consideration

[31] Office of the Comptroller of the Currency, "Bulletin 2017-43 – Description: Risk Management Principles," October 20, 2017. Available at: https://www.occ.treas.gov/news-issuances/bulletins/2017/bulletin-2017-43.html.

of the potential market impact of the new activities. Fortunately, the process envisioned in the proposed rule could assist FHFA in meeting this objective. Any determination regarding the capital requirements associated with new activities would be incomplete without an analysis of their market impact and the risks they may pose to the Enterprises or other market participants. As such, FHFA should incorporate its capital analysis for new activities into its process for determining whether or not to approve these activities. Doing so would produce a more robust and thorough approval process that ultimately benefits the entire market.

Open questions:

- What costs and benefits would come from making the Enterprises' interim capital treatment of new activities, or FHFA's determination of a final capital treatment of new activities, subject to public notice and/or comment?

- How would the process described in the proposed rule need to be amended to reflect current and prospective risk management principles that apply to banks?

- How does the process described in the proposed rule address non-credit risks associated with new activities?

Leverage-Based Minimum Capital

While risk-based capital requirements provide detail and granularity to the treatment of financial institutions' balance sheets and business activities, global regulators have widely recognized the value in supplementing such risk-based requirements with leverage-based minimum capital requirements. Typically, leverage capital requirements are calculated based on total assets or exposures without regard to the risk associated with those assets or exposures, except to the extent they are netted in an approved manner under applicable accounting standards. As such, they ensure that financial institutions maintain a minimum level of required capital, even if those institutions are deemed nearly credit-risk-free in their risk weighting profiles.

Importantly, the presence of a leverage-based minimum capital requirement also puts a floor on required capital as a safeguard against dramatically inaccurate assumptions regarding the riskiness of various assets and exposures. While inaccurate risk weightings could result in risk-based requirements well below the necessary capital for an institution to weather a severe stress scenario, the presence of a minimum leverage capital requirement—depending on its level—could prevent a shortfall.

In the preamble to the proposed rule, FHFA notes that it "seeks to avoid setting a minimum leverage requirement that is too high and would regularly eclipse the risk-based capital requirements."[32] The concerns raised by FHFA are certainly valid, particularly with respect to a binding leverage ratio as an incentive for the Enterprises to hold riskier assets or reduce CRT coverage. The severity of these concerns in terms of Enterprise safety and soundness would depend in part on the gap between the risk-based and minimum capital requirements when the leverage ratio is the binding constraint. If this gap is small, then a modest shift towards riskier assets would likely push the risk-based requirement above that implied by the leverage-based minimum capital requirement, making the risk-based standard the binding constraint once again. If this gap is large, however, the Enterprises could meaningfully increase their risk profiles without triggering higher capital requirements.

Based on the information provided in the proposed rule, it is unclear how the gap between the minimum and risk-based requirements would evolve under varying scenarios—both in the case of the 2.5 percent alternative and the bifurcated alternative. It is also unclear under what macroeconomic or financial scenarios the leverage requirement would serve as the binding constraint.

As with the risk-based capital requirements, FHFA should consider the similarities and differences between the proposed leverage requirements for the Enterprises and those in place for the largest global banks. For example, the proposed rule specifies that the minimum capital requirement would include total (on-balance-sheet) assets, but limits off-balance-sheet obligations to only those associated with securitization. Large banks, however, do not receive carve-outs for off-balance-sheet obligations or exposures based on the nature of a particular guarantee or line of credit.

The proposed Enterprise leverage-based minimum capital requirements also differ from those applied to large banks in their recognition of Generally Accepted Accounting Principles (GAAP). While the Enterprise requirements are measured in accordance with GAAP, bank requirements are typically adjusted due to netted positions and potential future exposures that may not be captured under GAAP. Though current law requires FHFA to utilize GAAP measures in the numerator of the leverage (and risk-based) ratio, it is not bound to do so when calculating the denominator. FHFA may therefore wish to explore the implications of using a more bank-like approach to the calculation of total assets and exposures of the Enterprises for purposes of instituting leverage requirements.

[32] 83 Fed. Reg. at 33314.

Open questions:

- Under what scenarios is the leverage-based minimum capital requirement expected to become the binding constraint on the Enterprises? How does this differ between the 2.5 percent alternative and the bifurcated alternative?

- How does the gap between the minimum capital requirement and the risk-based capital requirement differ under varying scenarios? What does this imply for the ability of, and incentives for, the Enterprises to shift towards riskier assets?

- With respect to the bifurcated alternative, what is the potential for the risk differential between trust and non-trust assets to change under periods of stress?

- With respect to the bifurcated alternative, is the higher capital requirement on non-trust assets intended to supplement the existing dollar limits on the Enterprises' retained portfolios? How is this dynamic expected to change in a post-conservatorship scenario in which the Enterprises are not subject to the conditions of the PSPAs?

- What is the rationale for considering only off-balance-sheet exposures related to guarantees when calculating the proposed Enterprise minimum capital requirements?

- What is the rationale for applying GAAP standards to the calculation of the proposed Enterprise leverage-based minimum capital requirement in a way that differs from the requirements of banks?

Stress Tests

Another critical pillar of the post-crisis regulatory framework is the use of stress testing to estimate the impact that various financial and macroeconomic scenarios would have on the financial health of larger institutions. The Dodd-Frank Act[33] includes a requirement that "… financial companies that have total consolidated assets of more than $10 billion and are regulated by a primary Federal financial regulatory agency shall conduct annual stress tests."[34] FHFA has published projections of the Enterprises' financial performance under various stress scenarios

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[33] 12 U.S.C. § 5365(i)(2)(A).

[34] Note that asset thresholds for stress testing were recently changed as a result of the Economic Growth, Regulatory Relief, and Consumer Protection Act, passed into law in May 2018.

since 2010 and has conducted the stress tests required under the Dodd-Frank Act since 2014.[35]

As is noted in the preamble to the proposed rule, FHFA has "generally aligned the stress scenarios for the Enterprises with the Federal Reserve Board's supervisory scenarios for annual stress testing."[36] Further, "Since … 2014, the severely adverse scenario has generally represented economic conditions similar to those that occurred during the 2008 financial crisis."[37] This benchmark for the level of stress that the Enterprises must be able to withstand is very reasonable, as the 2008 financial crisis represents a recent example during which a severe, national downturn was sustained in both the housing market and the broader economy. Moreover, there is abundant data available regarding the absolute and relative performance of different cohorts of loans over this period.

The scenarios contemplated in future stress tests must be sufficiently dynamic to ensure adequate capital retention for both the single-family and multifamily businesses of the Enterprises. In particular, FHFA should consider using multiple reference periods as benchmarks for future stress tests. While the 2008 financial crisis featured a severe downturn in the single-family housing market, the multifamily market fared much better. Based on the multifamily risk weights used in the proposed rule, it appears that FHFA contemplated a different—or possibly multiple different—historical experiences to represent stress for the Enterprises' multifamily businesses.

These potential stress scenarios raise legitimate questions regarding the importance of consistency in the treatment of the single-family and multifamily businesses. Because both business lines contribute to the overall financial health of the Enterprises, it may be reasonable to focus on a reference period in which a severe stress in one business line can (and did) occur without a severe stress in the other. For example, it may be that shocks to the homeownership market lead to a greater demand for rental homes, and hence the multifamily market serves as a buffer to losses at the Enterprise level. Potential safety and soundness concerns could be even better understood if the single-family and multifamily business lines were subjected to similarly severe stress tests—which could require the stress tests to draw from differing reference periods for each business line.

These options are not mutually exclusive. In developing future stress tests of the Enterprises, FHFA could publish unified results across both business lines based on

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[35] FHFA, "Fannie Mae and Freddie Mac Reports." Available at: https://www.fhfa.gov/AboutUs/reportsplans/Pages/Fannie-Mae-Freddie-Mac-Reports.aspx.

[36] 83 Fed. Reg. at 33324.

[37] Id.

a severely adverse scenario (as is currently the practice), while also conducting a separate stress test that contemplates significant, different stresses across each business line. From a capital adequacy perspective, this exercise would likely increase FHFA's understanding of how the separate business lines at the Enterprises act to offset or exacerbate stress for the institution in the aggregate.

Open questions:

- What reference period(s) are most relevant to consider with respect to the potential for losses in the multifamily business lines of the Enterprises?

- Is there benefit to future investors in Enterprise securities and Enterprise debt, as well as policymakers and the general public, in understanding how varying stress scenarios impact the Enterprises' single-family and multifamily businesses differently?

The Virtue of an Iterative Process

As the numerous comments and questions above make clear, much more information is needed to understand the full implications of the proposed rule. In particular, the rationale for various similarities and differences in the proposed rule relative to the capital frameworks for banks and other large financial institutions needs to be better articulated or more carefully considered. Questions regarding both risk-based and leverage-based minimum capital standards also warrant additional analysis—much of which depends on information not yet released by FHFA or the Enterprises.

The need for more information and analysis is not a critique of the proposed rule, but rather evidence of the benefits of an iterative process. As with the capital frameworks for other large financial institutions, the complexity of the proposed rule implies many overlapping and interacting effects and incentives. Requirements that address one type of risk could have significant consequences for other types of risk, and these consequences could vary across market conditions.

MBA considers the best approach for identifying these issues and making the necessary modifications as one characterized by a back-and-forth interaction between FHFA and interested stakeholders. A multi-round notice-and-comment process, like those common in the development of other regulatory capital frameworks, would give FHFA the opportunity to address questions raised in early iterations and fine tune the proposed rule over time, improving it in stages as it moves closer to becoming final. Similarly, once FHFA provides further specificity regarding some of the inputs and assumptions supporting the framework, a multi-

round notice-and-comment process would give stakeholders the ability to offer more useful input and analysis—particularly with respect to quantitative impacts.

Given the crucial role of the Enterprises in the housing finance system, as well as the massive scale at which they operate, the stakes for a robust capital framework are high. While FHFA is very much correct that "it is appropriate to update the Agency's standards … to provide transparency … about FHFA's supervisory view,"[38] the continued suspension of the Enterprise capital standards affords FHFA the requisite time to engage in a multi-round notice-and-comment process. Even if Congress passed legislation in the near term to end the conservatorships, it is virtually assured that a lengthy transition period would follow. While the Enterprises and investors would need certainty regarding the regulatory framework as the Enterprises (or successors or new entrants) undertake capital raises, MBA believes there is room for continuing adjustments during this period, particularly because any structural changes embedded in the legislation would likely necessitate changes to the capital framework.

More simply, a process that includes FHFA's response to the issues raised by this proposed rule, along with additional rounds of public notice and comment, provides the best avenue for a thorough, well-developed final rule that achieves the regulatory purposes discussed above.

Conclusion

MBA appreciates the substantial contribution FHFA has made to the development of a more robust capital framework for the Enterprises—both during conservatorship and in a post-conservatorship system. The proposed rule represents an important step in this process.

In order to further improve upon the proposed rule, MBA urges FHFA to reconsider some of the design features that add to the procyclicality of the risk-based capital framework. For the system to function properly, market participants must be confident that the Enterprises or any future guarantors are sufficiently safeguarded against the inevitable downturns in the housing market or the broader financial markets. If these guarantors are instead releasing capital at exactly the time they should be building stronger buffers, that confidence will not be achieved. Instead, guarantors should operate under more stable capital requirements that reflect their long-term role in the market.

While the proposed rule is highly detailed and addresses a variety of relevant risks posed by the Enterprise business models, we believe FHFA should proceed with an

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[38] Id. at 33312.

iterative, multi-round notice-and-comment process. Such a process would better allow for informed input from a variety of stakeholders, particularly as further information, calculations and assumptions underpinning the proposed rule and the CCF are made public. MBA stands ready and willing to assist FHFA as it undertakes this process.

Should you have questions or wish to discuss these comments, please contact Bruce Oliver, Associate Vice President of Commercial/Multifamily Policy, at (202) 557-2840 and boliver@mba.org or Dan Fichtler, Director of Housing Finance Policy, at (202) 557-2780 and dfichtler@mba.org.

Sincerely,

Robert D. Broeksmit, CMB
President and Chief Executive Officer
Mortgage Bankers Association

cc: Alfred M. Pollard
General Counsel
Federal Housing Finance Agency