Whalen Global Advisors LLC

June 2, 2020

Federal Housing Finance Authority
Eighth Floor,
400 Seventh Street, SW,
Washington, DC 20219
RE: RIN-2590-AA95

Dear Sirs,

With respect to the request for comment on RIN-2590-AA95, "Enterprise Regulatory Capital Framework," please see our comments below.

The Business Model

First, as a general matter, we note that the proposed rule does not discuss the future business models of the **Federal National Mortgage Association (FNMA)** and the **Federal Home Loan Mortgage Corporation (FHLMC)**, together the "GSEs." The implicit assumption in the capital requirements outlined in Table 1 of the proposed rule appears that the business models of the two entities will remain the same after exiting conservatorship. We believe that this assumption is misplaced and that FHFA need present its assumptions about the future business of the GSEs as private issuers *before* prescribing capital rules.

At present, the two GSEs are configured as nonbank finance companies that purchase conventional loans, issue mortgage backed securities (MBS) secured by these loans, and act as guarantor with respect to the loans and the MBS. Under the Preferred Stock Purchase Agreements with the Treasury, the MBS issuance (but not other unsecured debt) of the GSEs is guaranteed by the United States. Here are some of the key issues that FHFA need address in a capital proposal about the future business model:

1. Credit Rating: As private issuers of MBS, what is the target credit rating, equity returns and funding costs being assumed by FHFA for each enterprise? How do these targets compare to other nonbank mortgage companies on those three key factors?

2. Business Model: If the GSEs are no longer "AAA" rated issuers, what business lines will need to change or be eliminated entirely in order to remain profitable? Can the GSEs function as guarantors of MBS, for example, without a "AAA" credit rating?

3. Level Playing Field: After leaving conservatorship, will the GSEs issue private label MBS or a government guaranteed security? Will other private issuers also be allowed to purchase government insurance for conventional MBS? Also, will the GSEs be allowed to issue unsecured term debt to fund their capital needs?

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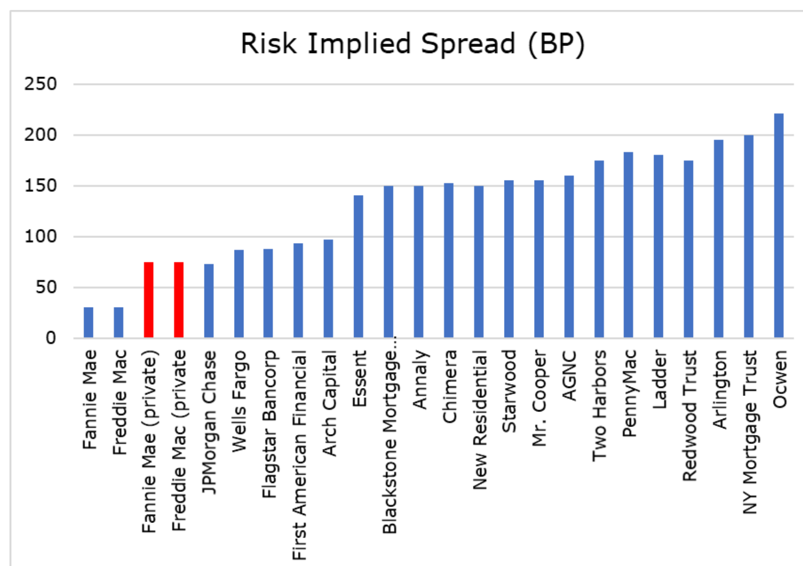
We note that while the GSEs have been operating under conservatorship, they continue to finance their operations and charge MBS guarantee fees as government monopolies, much as they did prior to 2008. Before or upon leaving conservatorship, however, these issuers will no longer be viewed in the credit markets as government-controlled and will presumably face a reduction in their respective credit ratings and a commensurate increase in their funding costs. FHFA's rule proposal is silent on this key issue.[1]

At present, both GSEs are rated "AAA/AA+" by the Moody's and Standard & Poor's credit rating agencies, respectively. As and when the GSEs eventually exit conservatorship, however, it is likely that the ratings of these two private issuers will change. WGA LLC estimates that assuming the GSEs raise most or all of the private capital required by FHFA, each enterprise would eventually have roughly a "A" unsecured rating from Moody's post-conservatorship.

Today the unsecured debt of the GSEs trade 30-40bp over the Treasury yield curve, roughly in line with credit default swaps for these two government sponsored issuers. On or before leaving conservatorship, however, the GSEs would likely see their bond yield and CDS spreads double or treble to just near that of large money center banks.

The chart below shows the risk-implied credit default spreads (CDS) for a selected group of GSEs, banks and nonbanks active in the secondary mortgage market. Implied CDS spreads for the GSEs post conservatorship assuming a "A" unsecured credit rating from Moody's are shown in red.



Source: Bloomberg, WGA LLC (5/22/20)

Assume, for example, that the GSEs have retained sufficient capital to exit conservatorship. It is likely that both issuers would see their unsecured corporate debt ratings fall to ~ "A" or roughly the same as most large commercial banks and a couple of notches above the highest rated nonbank mortgage companies.

[1] See "Federal National Mortgage Association and Federal Home Loan Mortgage Corporation," *Moody's Investors Service*, May 28, 2020. "An increase in capital levels would significantly improve their ability to absorb unexpected losses without support from the Government of United States of America (Aaa stable). However, even with a material increase in the GSEs' capital levels, the companies' very high ratings will continue to reflect our expectation of an ongoing high level of government support."

As a practical matter, under the ratings criteria for nonbank finance companies published by Moody's, it is not possible to achieve a high investment grade unsecured debt rating without full sovereign credit support.[2] So long as the GSEs are in conservatorship, the markets will construe their corporate guarantee on the MBS as carrying the full faith and credit of the United States.

Once the GSEs leave conservatorship, however, and see their unsecured credit ratings fall several notches, it is unclear whether any MBS investor will continue to find value in the GSE credit guarantee. Given FHFA's responsibility for the safety and soundness of the GSEs, the agency must opine publicly on how it sees the finances and operations of the enterprises post-conservatorship, including whether this key business line of selling credit guarantees will continue to be viable.

Looking at the credit risk transfer (CRT) obligations of the GSEs, for example, the triple-digit credit spreads suggest that, post-conservatorship, the GSEs would have a cost of capital in line with the better performing nonbanks rather than the large global bank SIFIs. Last year, Wells Fargo Securities showed implied guarantee fees of 10bp for 2019 CRT deals vs 15-20bps for 2018 vintages. Today, the "BBB" rated tranches of the GSEs CRT deals trade in the 500bp range over the Treasury curve.

Investor losses on levered CRT positions in March and April may have killed the market for CRT paper for years to come. Again, the FHFA capital proposal is silent on recent developments in the CRT market and how CRT will be used in future. FHFA notes (Page 18) that "CRT does not have the same loss-absorbing capacity as equity capital," but does not elaborate on this point.

If the GSEs cannot treat loss sharing agreements as a part of capital, how then will FHFA fashion a capital plan for the GSEs that is credible in the private capital markets? Will investors even care about CRTs once the GSEs as issuers are private? How should the cost of capital for Fannie and Freddie post-conservatorship compare to say **PennyMac (NYSE:PMT)**, especially if the issuers and their new MBS are not wrapped by a sovereign guarantee?

Many observers in Washington seem to think that the GSEs have the option to *raise* guarantee fees after exiting conservatorship. In order to assess this assumption, the FHFA needs to provide a competitive analysis of the future operations of the GSEs vs the large banks and nonbanks in the secondary loan market. Even if the GSEs continue to see demand for their corporate guarantee on conventional loans and agency MBS after leaving conservatorship, we think it likely that both enterprises will be forced to *reduce guarantee fees* in order to compete with the large banks and nonbanks that operate in the secondary mortgage market.

The GSEs charge about 55bp guarantee fee on a new loan (40bp annual and 15bp upfront). Would the GSEs be able to compete with **JPMorgan Chase (NYSE:JPM)** if the bank were merely buying conventional loans and issuing private MBS without a guarantee and at a 50bp higher yield? Given that the tiny market for private label loans is an extension of the $2.8 trillion in bank owned 1-4s and HELOCS, how does the FHFA see the GSEs competing against the large banks in the secondary market? The FHFA must clarify key aspects of the GSEs' business models in future in order to assess the proposed capital rules.

[2] There are only two "AAA" rated corporate issuers in the US, **Microsoft (NASDAQ:MSFT)** and **Johnson & Johnson (NYSE:JNJ)**. Note that no commercial banks are "AAA" rated, even with the expectation of full sovereign support in the event of market distress. The published criteria of the major rating agencies contain structural obstacles to any federally insured bank or finance company achieving an unsecured rating above "AA." See also "Finance Companies Rating Methodology," *Moody's Investors Service*, December 10, 2018.

Take another example. If the GSEs were to act as low-risk conduits for mortgage issuance, then the capital needs will be relatively low. But if the GSEs continue current business lines, which evolved under government control and reflect the duopoly pricing that requires sovereign credit support, then Fannie Mae and Freddie Mac will need far more capital to compete directly with the largest banks and nonbank aggregators.

Private vs Sovereign Capital

Although the two federally chartered corporations known as the GSEs have raised common and preferred equity capital from the public over the past half century, the reality of government control never ended. From an historic perspective, the fact of private capital had little or no impact on the financial standing of either GSE in terms of credit rating, or funding and capital costs.

Since the 1970s, the agencies assigned "AAA" ratings to Fannie Mae and Freddie Mac as issuers of MBS on the assumption that each enjoyed the sovereign support of the United States. The economic and financial reality of the backing of the Treasury for the GSEs is reflected in their low cost of funding and the fact that they are rated "AAA/AA+" in line with the US rating. Until the 2008 financial crisis, the GSEs essentially were treated as *de facto* government agencies. Going back decades after the privatization of the GSEs by President Lyndon Johnson, officials of the U.S. Treasury and the Federal Reserve System regularly referred to the fact that the GSEs were backed by the full faith and credit of the United States. [3]

As a general rule, no private bank or finance company can achieve a "AAA" unsecured rating without either (1) explicit credit support from a similarly rated sovereign nation or (2) substantial amounts of credit enhancement, as in the case of the senior tranche of an asset-backed security. Large depository institutions, for example, tend to receive a notch of ratings uplift because of the expectation of sovereign support, but the parent bank holding companies that issue debt and equity to investors do not.

Moody's wrote in March:

> "On 12 March, we affirmed the Aaa unsecured bond ratings of Fannie Mae and Freddie Mac and kept the outlooks stable. The affirmation of the companies' Aaa long-term senior unsecured debt ratings reflect our unchanged assessment that, despite a lack of an explicit (formal) guarantee, the two GSEs' creditors benefit from very strong support, contractual and extraordinary, from the government of the US (Aaa stable). A decline in the probability of extraordinary government support following a release from conservatorship could result in a downgrade of the two companies' Aaa unsecured debt ratings. Further, we believe some business and capital structures being explored, such as amending the PSPAs and implementing a credible resolution framework, would also reduce the probability of government support, as would any other changes that materially reduce the companies' market share." [4]

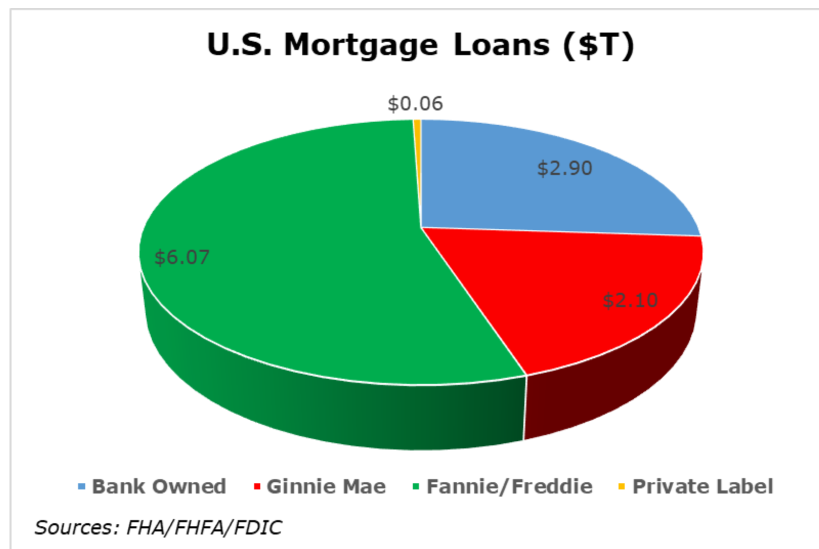
[3] November 15, 1982 letter from Roger W. Mehle, Assistant Secretary, U.S. Treasury to Robert Mebus of Standard & Poor's. S&P subsequently assigned a "AAA" rating to the senior debt and mortgage backed securities issued by Fannie Mae and Freddie Mac based upon "an individual analysis of the financial strength of each entity and its relationship with the U.S. Government." H/T Ed Pinto at AEI.

[4] "Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, Conservatorship exit will reduce probability of extraordinary government support," *Moody's Investors Service*, March 31, 2020

When or even before the GSEs are released from government control, the unsecured debt ratings of both likely will be downgraded by the major rating agencies. While it is difficult to predict future rating actions, assuming the GSEs raise much of the capital required in this proposed rule, the lack of explicit sovereign support would probably result in a 1-2 notch downgrade to an approximately "A" unsecured rating. A great deal will depend upon the business models and market credit spreads of both GSEs prior to and at the time of release from conservatorship. Again, the FHFA proposal is silent on this important issue.

It is important to recall that the present-day risk metrics for the GSEs already reflect the negative credit impact of 2008, when the implicit guarantee investors had relied upon in the past became real and the GSEs were placed into conservatorship. But we cannot go back in time. The changes in law and regulation since 2008 regarding the GSEs, particularly the assignment of a 20 percent risk weight to GSE MBS under the Basle III bank capital rules, has changed the way banks and supranational investors view conventional loans and agency MBS.

Post-conservatorship, the unsecured debt and private label MBS of the GSEs would likely carry a 100% risk weight under Basle III rules. The obligations of Ginnie Mae, by comparison, have a zero-risk capital weighting for US banks. FHA/VA/USDA guaranteed loans require no SEC margin in gestational repurchase transactions. While the GSEs are in conservatorship, agency MBS are also considered zero risk weight, one reason why the Federal Open Market Committee has been willing to buy conventional pass throughs as part of its open market purchases.



Once the GSEs emerge from conservatorship, however, the assumption seems to be that the FOMC will no longer buy conventional MBS. When the GSEs leave conservatorship, it seems likely that both the unsecured debt and perhaps also the new MBS of the two GSEs will no longer be considered obligations of the United States. New issue agency MBS will no longer be TBA eligible. GSE risk will instead be priced as private corporate exposures that have a federal credit line with the US Treasury. Given these potential changes in the business models of the GSEs, considerations such as managing market share as discussed in Section VII.A.3.d seem secondary by comparison.

The FHFA proposal does not discuss any of the important structural issues affecting the credit standing of the GSEs and the secondary market, nor does it explicitly include in the capital proposal how such changes would impact the profitability and the safety and soundness of the enterprises. As a practical matter, it is impossible to assess the efficacy of the proposed capital model unless and until the FHFA provides more clarity on its assumptions as the business models of the GSEs. Specifically, we need to hear the FHFA's thoughts on sources of revenue, and capital and funding costs, post-conservatorship.

The Capital Model

The GSEs are not depositories but are instead the largest nonbanks operating in the US market, albeit for now with sovereign support. Imitating the Federal Reserve Board's approach to setting capital levels for large banks, FHFA seems intent upon imposing punitive, Basle III type capital requirements of the sort reserved for systemically significant depository institutions or "SIFIs." The table below provides a taxonomy of the world of residential mortgage finance sorted by the market beta of the common shares. The GSEs take substantial balance sheet risk by holding loans and securities, issuing guarantees, funding default repurchases and advances, and financing mortgage-servicing rights (MSRs). As private firms, however, the GSEs will not differ substantially from existing nonbank issuers.

Issuer	Price/Book (5/22/2020)	Beta (5Y/MTHLY)
Ladder	0.71	2.44
Freddie Mac	NA	2.16
Fannie Mae	NA	2.02
NY Mortgage Trust	0.43	1.95
Arlington Investment	0.44	1.81
New Residential	0.65	1.73
Flagstar Bancorp	0.82	1.70
Two Harbors	0.68	1.62
Starwood	0.83	1.46
Essent	0.96	1.42
Ocwen	0.21	1.34
Blackstone Mortgage Trust	0.86	1.31
Wells Fargo	0.62	1.19
JPMorgan Chase	1.19	1.18
Annaly Capital	0.86	1.15
Mr. Cooper	0.45	1.15
PennyMac	0.71	1.09
Redwood Trust	0.86	1.09
First American Financial	1.25	1.05
Chimera Investment	0.49	0.92
AGNC	0.88	0.90
Arch Capital	1.08	0.68
Average	0.71	1.43

Source: Yahoo Finance, WGA LLC

Note that while the GSEs currently sit at the top of the credit food chain due to the support of the United States, they are among the most volatile stocks among all large financials. This is a function of the continued uncertainty around the GSEs and when and how they will emerge from conservatorship. Notice too that the table above suggests that companies involved in mortgage finance trade below book value and with above average equity market volatility or beta.

The FHFA's capital proposal does very nicely outline all of the known financial and operational risks facing the GSEs, but in a backward-looking fashion that treats the GSEs as though they will continue to enjoy sovereign credit support indefinitely. Since the object here is to end conservatorship for the GSEs, we submit that a better approach would be to put aside bank centric capital models and instead benchmark the GSEs against the largest nonbank seller servicers in the conventional market. It is not small irony to say that the FHFA should use the same capital requirements for the GSEs as those it proposes to impose upon nonbank seller/servicers!

You cannot compare Fannie Mae and Freddie Mac with JPMorgan or **Wells Fargo (NYSE:WFC)** and force them to compete with the same prudential capital rules. The big banks will win hands down every time. Since the GSEs have limited their issuance of term debt in the capital markets, like other nonbanks they are dependent upon (1) equity finance and (2) borrowings from banks to finance their operations.

JPM and WFC each possess over $1 trillion in core deposits along with substantial payments float, access to the discount window and vast non-price subsidies. The GSEs have none of these advantages, only the limited support of the US Treasury. Banks will have cheaper funding and better execution than a private GSE. And like many nonbank lenders, the GSEs do not own their servicing strip but are ultimately responsible for all of the costs of ownership of residential mortgage loans (including default advances and repurchases). This makes them extremely vulnerable to changes in capital and/or funding costs.

Post conservatorship, the GSEs like all other nonbanks, will be the customers of the large commercial banks for advance financing, but they should also expand their footprint in the debt markets. To Question 22, for example, the FHFA should considering making a substantial portion of GSE capital financed in term unsecured debt rather than common equity or preferred shares. Locking in a deliberately structured schedule of long-term unsecured debt funding to meet GSE liquidity needs should be a priority for the FHFA before the enterprises exit conservatorship.

Conclusion

The FHFA capital proposal attempts to benchmark the capital requirements of the GSEs with that of the largest bank SIFIs. In the narrative to the rule, the FHFA makes clear that it seeks to not only ensure sufficient capital to remediate credit losses on insured loans, but to also provide sufficient mass financially to keep the enterprises liquid in a stressed economic scenario. Ensuring 100% safety against credit loss and market stress is not possible in an economic sense, raising basic questions about the FHFA capital framework.

If the GSEs could not withstand the liquidity stress of 2009, when Fannie Mae and Freddie Mac enjoyed the implicit backing of the United Stated but failed none-the-less, why does the FHFA think that simply requiring more private capital will make the GSEs better able to endure times of financial stress in future? Indeed, when we recall that the GSEs have historically been conduits for subsidized public financing of residential housing, the whole question of a transition to private capital seems absurd.

The FHFA notes in the capital proposal: "The Enterprises' losses continued to mount into 2008, their share prices rapidly fell, and the spreads on their unsecured debt and mortgage-backed securities (MBS) widened." Given this statement, why does the FHFA believe that the GSEs, largely supported by more than $200 billion in private capital and without sovereign credit support, would fare better in a future stressed scenario? Clearly any amount of private capital is inferior to a sovereign credit guarantee.

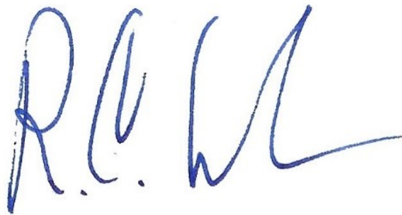
Far from justifying the proposition that private capital can indeed support half of the $11.5 trillion US residential mortgage market, this proposal raises numerous unanswered questions that together seem to suggest otherwise. The fact that the FHFA thinks it necessary to put a quarter of a trillion dollars in combined capital behind the GSEs suggests that no amount of private capital will suffice to make the residential housing market truly safe and sound. A transition to private "ownership" seems to promise only future instability and public bailouts as we pretend that we can have an efficient, homogenous market for residential housing finance without government support.

In the near term, both GSEs face a significant credit costs due to the lockdown and related economic disruption of COVID19. But medium to long-term, the real question that has not been answered is this: What will the GSEs look like as and when they exit conservatorship? As we've noted above, once you start to move towards ending sovereign credit support for the GSEs, everything starts to change and not in a particularly good way.

In any privatization scenario, we expect to see GSE financing and operating costs going up and revenue under equal downward pressure. Until the FHFA and the GSEs themselves start to address some of these financial and business model issues with greater specificity, we believe that the FHFA is going to encounter great difficulty in moving forward with the end of conservatorship for Fannie Mae and Freddie Mac.

We are happy to discuss these comments.

Yours sincerely,



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