7/6/2020

Alfred M. Pollard, General Counsel

Attention: Comments/RIN 2590–AA95

Federal Housing Finance Agency

Eighth Floor, 400 Seventh Street SW

Washington, DC 20219

Re: Enterprise Regulatory Capital Framework (RIN) 2590–AA95

To Whom it May Concern:

The American Action Forum (AAF) experts appreciate the opportunity to submit comments on the notice of proposed rulemaking ("proposed rule") amending capital requirements for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, "the Enterprises"). This rule has been proposed by the Federal Housing Finance Agency (FHFA) and the Office of Federal Housing Enterprise Oversight (OFHEO) within the Department of Housing and Urban Development (HUD) (collectively, "the Agencies").

AAF is an independent, nonprofit 501(c)(3) organization. Its focus is to educate the public about the complex policy choices now facing the country and explain as cogently and forcefully as possible why solutions grounded in the center-right values that have guided the country thus far still represent the best way forward for America's future.

As one of this comment's authors noted in a dissenting statement to the Financial Crisis Inquiry Commission's report on causes of the financial crisis of 2007-2008, "Fannie Mae and Freddie Mac did not by themselves cause the crisis, but they contributed significantly in a number of ways…as large financial institutions whose failures risked contagion, they were massive and multidimensional cases of the too big to fail problem. Policymakers were unwilling to let them fail…."

After deeming the Enterprises "too big to fail," the FHFA took them into financial conservatorship and suspended their capital requirements. What was always expected to be a temporary solution has not proven to be so, and over a decade after the Enterprises remain in conservatorship. This status quo is not sustainable. The process of socializing losses and privatizing profits is not a viable long-term solution, and the Enterprises must be returned to the responsibility of their shareholders.

Ten years after the Housing and Economic Recovery Act (HERA) introduced safety and soundness regulations that included requiring the FHFA Director to advance a risk-based capital framework for the Enterprises, the FHFA released a proposal to do precisely that in June 2018, at

a time when reform of the Enterprises was considered an unlikely notion. In November 2019, the FHFHA announced that it would be re-proposing the entire 2018 capital rule; the re-proposed rule, modifying the 2018 rule, was announced after some delay in late May 2020.

Both the 2018 and 2020 proposed capital rules would require the Enterprises to hold the higher of either a minimum leverage ratio or a risk-based capital requirement. The minimum leverage ratio would require the Enterprises to hold either capital equal to 2.5 percent of total assets or capital equal to 1.5 percent of trust assets and 4 percent of non-trust assets, and in spirit is derived from the 1992 Federal Housing Enterprises Financial Safety and Soundness Act. The risk-based capital requirement, which follows the approach of the Basel requirements, mandates that the Enterprises hold capital equal to 8 percent of risk-weighted assets (RWAs). The minimum leverage requirement appears to be the more onerous, and therefore more likely to be binding, requirement in that it would require the GSEs to hold 4 percent in adjusted total assets. As of September 2019, the GSEs held a combined $6.1 trillion in assets. Using this as a rough guide, the GSEs would have to hold – at minimum – a combined $244 billion in capital. The two together currently hold about $23.5 billion.

With this the FHFA appears to have indicated that holding something in the region of $240 billion would represent sufficient capitalization of the Enterprises. Any identified capital requirement was of course destined to invite controversy. Set the requirement too low, and the GSEs would not be adequately capitalized in a crisis; set them too high, however, and the cost of capital, along with the cost of mortgages, would significantly increase. In addition, a risk-based capital requirement is a complicated proposition given the inability to apply a sensible risk-weighting to assets held by government-backed institutions. Even if the line of credit to Treasury were removed, the recapitalized Enterprises will presumably have entirely different charters and mandates; they will have fundamentally different balance sheets and risk appetites, both of which will drive significant differences in pricing structures. How can risk be appropriately priced for what is currently a public body?

Alternately, a 2.5 percent minimum leverage ratio appears low by comparison to the 5 percent minimum typically applied to community banks, which have fundamentally less risky business models, let alone the capital requirements that apply to the largest banks, ranging from 12 to 18 percent. Significant legislative efforts in Congress (both the Johnson-Crapo initiative and the Corker-Warner bill) fixed on 10 percent as being the appropriate gauge. How then to justify 2.5 percent?

The 2020 capital rule does, however, make substantial improvements over the 2018 rule. The re-proposed rule also includes a variety of additional capital buffers common to the banking world that would be applied to the GSEs. The minimum leverage ratio assessment contains a new requirement that 2.5 percent of adjusted total assets be Tier 1 capital, the safest and most "perfect" form of bank capital. The risk-based capital requirement, in addition to requiring 8 percent RWAs, applies a number of other capital buffers, including a stress capital buffer, a stability capital buffer, and a countercyclical capital buffer. These buffers would increase the risk-based capital assessment by about $100 billion from the 2018 capital rule proposal. These additional capital buffers are supplementary, however, and the 2020 proposal suggests that

instead of necessarily being factored into the capital calculation and required of the GSEs ab initio, the FHFA might use this higher requirement to determine whether Fannie and Freddie would be fit to, for example, make dividends or provide discretionary bonuses.

The addition of these stress capital buffers, adopted from regulatory requirements in banking, represents a far more thoughtful and nuanced take on the capital requirements of what would be financial titans if released from conservatorship. Further, these buffers address a key criticism of the 2018 proposal – that GSE capital requirements would be unintentionally procyclical. Providing these new supplementary buffers – most notably the countercyclical buffer – provides the GSEs with funds in time of need to provide a countercyclical force to the market as required.

Despite these enhancements, the key focus must be consideration as to $244 billion as an acceptable level of capitalization for the Enterprises. It is worth noting that the comprehensive capital requirement is higher than the market expected. Requiring the Enterprises to increase their capital reserves by a factor of 10 is a considerable ask, even without the additional new Tier 1 requirements. Not only will this take time, during which the Enterprises will presumably remain in conservatorship, but it may be difficult to attract outside investment.

We believe, however, that the proposed capital requirement remains too low. Under Director Calabria the Enterprises' leverage ratio has dropped from 1,000 to 1, to 500 to 1, to 250 to 1. Although this is an extremely positive direction for the Enterprises, by contrast, the average bank is leveraged at a ratio of about 12 to 1. Even though it is heartening to see the capital buffers used in the banking world applied to the hypothetical privatized Enterprises, the comprehensive capital requirement is still lower than if they were banks. A hypothetical $240 billion of private capital standing in front of the GSEs in the event of crisis would of course be reassuring, but would it be enough to stave off a second collapse? Would the GSEs remain too big to fail?

In addition, two significant unknowns remain. First, there remains a risk that the FHFA could seek to release the Enterprises prior to having obtained a desired level of capitalization under a consent order. This proposal is silent as to this possibility, but the high core capital requirement and Director Calabria's desire to get the Enterprises out of conservatorship as quickly as possible renders this a not-unlikely result. Allowing the Enterprises to resume operations prior to identified capital requirements would be a risky proposition. Second, common sense would seem to dictate that two such enormous institutions would have to be deemed "systemically important," and therefore fall under the purview of the Financial Stability Oversight Council (FSOC). FSOC would under its own mandate apply capital requirements to Fannie and Freddie, and if the banking experience is at all analogous, these requirements would be higher than those set by the existing federal regulator – although that is a problem for the Enterprises out of conservatorship. The capital rule should be considered less as a tool for regulating and supervising the Enterprises in this hypothetical but more as the FHFA's goal for assessing the appropriate amount of capital required before triggering that release.

If the 2018 capital rule proposal represented "fantasy rulemaking," the 2020 proposal is still predicated on the same hypothetical – the release of the GSEs from conservatorship. As noted, however, the Enterprises have undergone significant reform and the FHFA appears committed to removing the conservatorship within the next two years. Similarly, the 2020 capital rule proposal

is a measured and appropriate take on bank capital requirements that could be applied to Fannie and Freddie out of conservatorship. Despite these improvements, however, and the basic fact that $240 billion of private capital in the event of crisis is better than none, the comprehensive capital requirement still appears far too low to adequately reflect the risk that the Enterprises pose to the economy. The highly volatile nature of the housing market and the inelasticity of housing supply suggests that the Enterprises will play a key role in the next financial crisis. It can only be hoped that by that time the leverage and footprint of the Enterprises will have been significantly reduced and that an appropriate level of capital can protect the taxpayer by standing in front of the Enterprises, regardless of whether or not the Enterprises remain in conservatorship.

AAF stands ready to provide research and additional assistance to the FHFA and other interested parties as needed.

Sincerely,

Douglas Holtz-Eakin, President, American Action Forum

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