August 26, 2020

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

Re: Enterprise Regulatory Capital Framework; RIN-2590-AA95

Dear Mr. Pollard:

JPMorgan Chase Bank, N.A. ("Chase," "we," or "our") appreciates this opportunity to share with the Federal Housing Finance Agency ("FHFA") our comments on the FHFA's Enterprise Regulatory Capital Framework; RIN-2590-AA95 (the "Proposed Capital Rule"). Chase is one of the largest originators and servicers of residential mortgages in the United States and JPMorgan Chase & Co., through its subsidiaries, is active in all aspects of the U.S. housing finance industry, including as an originator, purchaser and seller of home loans, as well as an underwriter, issuer, distributor, and investor in mortgage-backed securities ("MBS"). Accordingly, we draw on a broad base of experience in offering our comments to the Proposed Capital Rule.

A sound regulatory capital framework, while essential to enable Fannie Mae and Freddie Mac (the "Enterprises") to achieve an orderly exit from conservatorship without destabilizing the secondary mortgage market, should not be designed solely with exit as a goal or with a particular end state in mind. FHFA should design a capital framework that will be durable through economic cycles and unaffected by any potential post conservatorship end state. To meet this objective, the capital framework should adhere to the following five core principles:

1. Facilitate the transfer of as much risk as possible to private investors to optimize the Enterprise's capital use, lower overall risk and, therefore, safeguard taxpayers from mortgage credit risk while ensuring robust, nationwide access to mortgage credit for American families.
2. Leverage credit risk transfers to integrate market feedback in the calibration of guarantee fees.
3. Preserve the smooth functioning of the To-be-Announced ("TBA") market through and after a transition out of conservatorship.
4. Be as clear and simple as possible to ensure durability under stress, preserving optionality to optimize the post-conservatorship end state.
5. Provide for transparency and appropriate monitoring by FHFA.

This letter focuses on the importance of a robust credit risk transfer ("CRT") program as being foundational to enabling the Enterprises to continue to perform their critical mission in times of stress while limiting the risk to U.S. taxpayers.

Summary

We are mindful of the comments that will be submitted by industry trade groups and generally endorse their call for a closer examination and re-calibration of the interactions among the risk-based-capital ratios, buffers and the leverage ratio, but intentionally express no opinion on their calibration.[1] Instead, we focus our comments on the importance of preserving a capital framework that facilitates the Enterprises maintaining a robust CRT program in the final rule. Accordingly, we incorporate by refence in this letter the independent research from J.P. Morgan Securities LLC ("JPMorgan"),[2] showing how "[a]capital framework that abandons CRT leaves the FHFA without a useful tool for setting guarantee fees – the fundamental lever in the business" and a key component to ensure the smooth functioning of the TBA market.[3]

As we have stated in a prior comment letter,[4] the TBA market is integral to the smooth functioning of the American mortgage system. Ensuring that investors in the Enterprises' MBS harbor no concerns about mortgage credit risk through and after the Enterprises' exit from conservatorship is essential to the smooth functioning of the TBA market, which is critical to ensuring the continued and stable flow of capital to the U.S. mortgage market, particularly in times of economic stress. A regulatory capital framework that encourages a robust and well-designed CRT program will assist the Enterprises in achieving those goals by facilitating the distribution of substantial credit risk to private investors. A well-designed CRT program also will allow for reduced mortgage guarantee fees by facilitating the generation of return on equity ("ROE") thresholds acceptable to equity investors while increasing the Enterprise's capacity to support the U.S. housing market.

The absence of a well-designed CRT program will reduce the Enterprises' resilience in adverse market conditions, cause higher guarantee fees, make it more difficult for the Enterprises to maintain the American public's access to affordable mortgages in times of economic stress, and potentially limit the range of options to enable the Enterprises to exit conservatorship in a manner that does not disrupt the TBA market. Therefore, it is essential that the final regulatory capital framework applicable to the Enterprises facilitates and encourages the maintenance of robust CRT programs.

CRT Allows the Enterprises to Optimize Capital Utilization

A framework that acknowledges the efficacy of CRT would allow the Enterprises to meet their overall level of required capital in a more efficient manner than a capital model that shifts the mitigation of mortgage credit risk to higher-cost corporate equity. Under most market conditions, we believe that CRT costs will likely be lower than the cost of equity and other forms of capital.

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[1] We commend, however, the letter submitted by the Housing Policy Council. It addresses comprehensively key considerations to optimize the Enterprises' capital plans regardless of end state post-conservatorship.

[2] JPMorgan is a marketing name for investment banking businesses of JPMorgan Chase & Co. and its subsidiaries worldwide. J.P. Morgan Securities LLC, an affiliate of Chase, performs securities, syndicated loan arranging, financial advisory and other investment banking activities.

[3] "You break it, you own it", North America Securitized Products Research, https://markets.jpmorgan.com/research/email/-pa5128c/-V4_mSm4bGjC_eIcpEGSWw/GPS-3447310-0.

[4] https://www.fhfa.gov//AboutUs/Contact/Pages/input-submission-detail.aspx?RFIId=1069.

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The Enterprises' risk transfer programs provide important risk management tools, including Fannie Mae's Connecticut Avenue Securities ("CAS") and Freddie Mac's Structured Agency Credit Risk ("STACR") securities. The value of the current CRT programs' contribution to transfer risk to the private sector and protect the Enterprises and the American taxpayers is acknowledged by the Enterprises.[5] Importantly, this is underscored by the Federal Reserve Bank of New York's research highlighting how the Enterprises' CRT programs have "improved the stability of the housing finance system and advanced a number of important objectives of GSE reform. In particular, the CRT programs have meaningfully reduced the federal government's exposure to mortgage credit risk without disrupting the liquidity or stability of secondary mortgage markets."[6]

Although the GSEs have experimented with a number of different risk transfer instruments, the CAS/STACR debt securities have been the most widely used, accounting for more than seventy percent of "risk-in-force," through the second half of 2019.[7] The CAS/STACR structures have several key benefits. The liquidity of the TBA market is not impacted by these structures because the loans referenced have been previously pooled into guaranteed MBS and sold in the TBA market. The CAS/STACR securities are fully collateralized by cash that private investors pay to purchase these securities. This means that the Enterprises have no counterparty or reimbursement risk with this structure. In this way, CRT markets enable efficient pricing of credit risk in a manner consistent with the TBA market's role in the efficient pricing of interest rate risk.

Accordingly, a well-designed CRT program should be an essential component to calibrate the right mix of common equity, buffers and other capital sources that are required to optimize the overall cost of capital protecting MBS investors while lowering the overall cost of mortgages. We believe that to be the case because a well-designed CRT program would provide the Enterprises an essential real-time, market-informed view regarding guarantee fees,[8] and allow FHFA and the Enterprises to respond and calibrate guarantee fees appropriately. Absent a well-designed Enterprise CRT program and a robust CRT market, the feedback loop may be delayed or disrupted, risking a mispricing of credit risk and, therefore, guarantee fees. Moreover, a robust CRT program would enable the Enterprises to lower their overall costs, facilitate the generation of appropriate ROEs to attract equity investors, and increase the overall capacity of the Enterprises to guarantee MBS and generate guarantee fee income with the same level of equity capital, thereby improving liquidity in the TBA market, and lowering mortgage costs for American families.

[5] In Fannie's case, see https://www.fanniemae.com/resources/file/credit-risk/pdf/cas-program-investor-presentation.pdf. For Freddie Mac, see http://www.freddiemac.com/perspectives/david_brickman/20200720_our_50_year_milestone.page.

[6] https://www.newyorkfed.org/medialibrary/media/research/epr/2018/epr_2018_credit-risk_finkelstein.pdf.

[7] From 2013 through the second quarter of 2019, the Enterprises transferred risk on approximately $3.1T of UPB, with a total RIF of $102B. Securities issuance (CAS an STACR) accounted for 71 percent of total RIF of CRT issuances. https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Progress-Report-2Q19.pdf.

[8] http://www.freddiemac.com/fmac-resources/perspectives/pdf/CRT-GFee-White-Paper-Final.pdf.

A Robust Credit Risk Transfer Program Aligns with Key Recommendations in the U.S. Treasury 2019 Housing Reform Plan[9]

The treatment of credit risk transfers in the Proposed Capital Rule is inconsistent with the specific recommendations in the Treasury Reform Plan for finding diverse, viable outlets to reduce the Enterprises' footprint[10] and broaden the mortgage credit box by using the capital markets to distribute credit risk to private investors. Following the recommendations in the Treasury Reform Plan should result in the Enterprises transferring more risk to private investors, and so the final Enterprise capital rule should seek to provide appropriate capital relief for credit risk transfers.[11] If this is not achieved, it will disincentivize the Enterprises from developing robust CRT programs and inhibit the transfer of risk to private investors.

To address the Treasury Reform Plan's recommendations, the Enterprises' CRT programs should be revised to ensure that each CRT issuance definitively, and without recourse, transfers significant credit risk to investors upon issuance and the final Enterprise capital rule should reduce capital charges commensurately with the risk transferred.[12] Investor cashflows from each CRT issuance should be linked to the performance of a defined pool of underlying loans, providing the originating Enterprise with first loss protection on the reference pool. Cash proceeds from each CRT issuance should be commensurate with the investors' obligation to absorb a defined level of credit losses on the reference pool.[13]

CRT programs should be designed to provide an economical means to transfer mortgage credit risk and lower the overall amount of equity and equity-like capital required. The final Enterprise capital rule should encourage the Enterprises to continue their CRT programs to enhance the Enterprises' role as distributors of mortgage credit risk by including or retaining these key features:

- Day-1, first-loss (net of MI coverage) risk transfer
- REMIC eligibility
- TBA eligibility
- Cash collateral

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[9] https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf?mod=article_inline (the "Treasury Reform Plan" hereinafter.)

[10] "[T]he reformed regulatory framework should not create capital arbitrage or other regulatory incentives that bias mortgage lenders toward securitizing their loans through guarantors." Treasury Reform Plan at p.3.

[11] [E]ach GSE should be recapitalized so that private capital takes the first-loss position on the GSE's exposure to risk and loss. (administrative)" Treasury Reform Plan at p.15.

[12] " …. In setting and adjusting the fees for Government guarantees of qualifying MBS, FHFA should consider:

- the expected fees and payments under the guarantee so as to endeavor to reduce the cost of the program, discounted on a risk-adjusted basis, to zero over a period that contemplates fluctuations in economic conditions consistent with historical experience;
- the conditions affecting the housing finance system so as to provide for reasonable stability in the fee, notwithstanding the varying risk through fluctuations in housing and economic conditions during that period; and
- any available pricing information associated with relevant private sector transactions (e.g., CRT transactions of guarantors)." Treasury Reform Plan at p.15-16.

[13] "Treasury Recommends: … FHFA should, in prescribing regulatory capital requirements, provide for appropriate capital relief to the extent that a guarantor, or a GSE pending legislation, transfers mortgage credit risk through a diverse mix of approved forms of CRT. (administrative)" Treasury Reform Plan at p.15-16.

- Public and private execution
- No implied support from the issuer
- Reflect actual, realized losses
- One-to-one reduction of RWA commensurate with risk of loss transferred
- Revising the treatment of forbearance to ensure CRT reflects realized Enterprise losses
- No hard call requirements (currently 10 years)

Conclusion

We fully support a modern and resilient Enterprise capital framework that relies on private investors to protect the Enterprises from credit losses. Credit risk transfers offer an indispensable tool to price mortgage credit risk appropriately, achieve required capital levels while reducing the aggregate quantity of corporate equity required, and reduce the US government's housing footprint and taxpayer exposure to mortgage credit risk. An Enterprise capital framework that encourages well-designed CRT programs that take advantage of market pricing and feedback mechanisms is critical to ensure the resiliency of the US housing market through the economic cycle and is essential to preserve the ability of the Enterprises to carry out their vital housing mission in support of U.S. families, particularly during times of economic stress.

Thank you for the opportunity to comment on the Proposed Capital Rule. We hope that our comments are constructive and assist you in designing an Enterprise capital framework that fully takes advantage of all the options currently available in the private investor and insurance markets to transfer and price mortgage credit risk to optimize loss absorption through all economic cycles. We believe that a capital framework that facilitates risk transfer is critical to a stable housing finance system, provides prudent access to affordable mortgage credit, protects taxpayers, and helps facilitate the homeownership aspirations for Americans for generations to come.

Sincerely,

Mark W. O'Donovan
CEO Home Lending