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To Members of the Federal Housing Finance Agency:

We appreciate the opportunity to submit these comments on the Federal Housing Finance Agency ("FHFA") 2020 notice of proposed rulemaking ("2020 Proposed Rule"). As a member of the Reinsurance Association of America, RenaissanceRe Holdings Ltd. ("RenaissanceRe") joins in the comments submitted by that industry organization and would like to expound upon the value that reinsurance companies bring to the Credit Risk Transfer ("CRT") market, Fannie Mae and Freddie Mac (the "Enterprises"), to the housing-finance market, and to the protection of taxpayers. We also respond to four of the questions posed by FHFA in relation to the 2020 Proposed Rule: Question 4 (at page 4), Question 23 (at page 7), Question 67 (at page 9), and Question 73 (at page 12).

The RenaissanceRe Group of Companies

Formed in 1993, RenaissanceRe is a global reinsurance and insurance company, which is publicly traded on the NYSE under the ticker symbol "RNR." Through our various operating subsidiaries, we help clients solve their most complex risk challenges by matching well-structured risk with efficient capital.

RenaissanceRe underwrites risk in numerous jurisdictions and accordingly its operating subsidiaries are subject to a high level of scrutiny from both regulators and rating agencies. When we were formed 27 years ago, RenaissanceRe was principally a reinsurer of property catastrophe risk. Today, we are a global multi-line reinsurer and leader in an ever-growing number of lines of business. As at December 31, 2019, RenaissanceRe's current portfolio is comprised of approximately $5 billion of Gross Written Premium ("GWP") and $17 billion in total managed capital across our subsidiary balance sheets. We have been an underwriter of mortgage risk globally since 2010 and an active participant in structuring and pricing US mortgage reinsurance transactions since the first placement following the Global Financial Crisis in 2013.

Executive Summary

We believe certain specific adjustments must be made before the FHFA can implement the 2020 Proposed Rule without undercutting the stated goals of the FHFA, and of Congress, for the Enterprises and for the US housing-finance system.

We agree on the need for an appropriate regulatory capital framework for the Enterprises and on the broad principles articulated, however there are elements of the rule that will impede the Enterprises, both from exiting conservatorship and from fulfilling their mission to support a competitive, liquid, efficient, and resilient national housing finance marketplace. As the Department of the Treasury cautioned in the September 2019 Housing Reform Plan, the Enterprises need requirements tailored to the risks they pose. Furthermore, given the importance of the housing-finance system to economic stability, changes should take careful account of the risks posed by the transition, and this generally counsels in favor of preserving what works in the current system.

The 2020 Proposed Rule falls short of this standard because it fails to preserve, and will instead eliminate, one of the principal mechanisms for risk reduction that works in the current system: the Enterprises' CRT program.

The 2020 Proposed Rule would negatively impact CRT and subsequently challenge the Enterprises with two principal mechanisms:

- **Increased and Oversized Leverage Ratio**: The 2020 Proposed Rule imposes a leverage ratio of 4% via the introduction of a 1.5% Prescribed Leverage Buffer Amount (“PLBA”). This is a 60% increase from the 2.5% proposed by the FHFA in 2018 and will materially penalize the Enterprises if they transfer credit risk to the private sector. As there is no CRT capital credit when the leverage ratio is binding, the leverage ratio actively penalizes the use of third-party risk transfer due to its detrimental effect on shareholder earnings, notwithstanding its risk-transfer benefits.

- **Significant Departures from Neutrality in Risk-Based Capital**: the proposed capital treatment for CRT materially departs from risk-driven standards and from capital neutrality through the inclusion of the newly introduced 10% Risk-Weight Floor and 10% Overall Effectiveness Adjustment. These two elements undercut the capital benefit of CRT to such an extent that it will be deemed an uneconomic purchase, despite its continuing real-world risk-transfer benefits.

In light of these severe, unintended consequences, RenaissanceRe proposes that the FHFA, consistent with its eight-year effort to encourage CRT as a mechanism for transferring risk to the

private sector, retain near capital neutrality and leverage ratios that have previously been determined to be adequate. This would be achieved through:

- **Leverage Ratio:** Restoration of the leverage ratio to the level set by the FHFA in its original 2018 proposal, being 2.5% of Adjusted Total Assets, via the elimination of the PLBA.

- **Risk-Based Capital:** First, an adjustment of the 10% Risk-Weight Floor for retained CRT to a 10% Risk-Weight Floor applied on the portion of retained CRT that is within 1.5 times the Weighted-Average Capital Requirements. Second, the removal of the 10% Overall Effectiveness Adjustment. This updated framework would more suitably correspond to the underlying risk of the transactions.

Value of CRT to the Enterprises

Over the past eight years the FHFA has fostered the development of a CRT market as a mechanism to sustainably reduce the risk of the Enterprises. To date, the CRT market has reduced the risk and volatility of the Enterprises and has protected the taxpayer, by transferring to the private sector credit risk on $3.5 trillion of unpaid principal balance. This has been done in a cost-effective manner that has supported the Enterprises, thus benefiting the US housing finance market, the American homeowner, and economic stability. As noted by Don Layton in his series of papers on CRT, the reform successfully implemented through CRT addresses five separate challenges faced by the GSEs:[1]

1. A reduction in systemic risk through passing risk to diversified investors.

2. A reduction in taxpayer exposure via transferring risk away that was originally covered under an implicit backstop during conservatorship, and by supplementing equity capital when under private ownership.

3. Introduction of market discipline via a feedback loop created on the pricing of individual CRT transactions.

4. A reduction in the cost of capital in a post-conservatorship framework through the access to competitive and diversified pools of investors who are pricing their product directly off the risk of default.

[1] https://www.jchs.harvard.edu/sites/default/files/harvard_jchs_gse_crt_part1_layton_2020_0.pdf

5. Improving the efficiency of guarantee fee pricing through reduction in the overall cost of capital.[2]

The FHFA was instrumental in ensuring that CRT effectively transfers risk, and is the ultimate arbiter of whether capital credit can be received on a given transaction. When suitably deployed, CRT can materially reduce the uncertainty in expected earnings streams and can protect the solvency of the Enterprises. This has already been demonstrated in 2020 as deteriorating credit conditions have put substantial strain on the housing market. Through the second quarter of 2020, Freddie Mac has reported a 36% reduction in the provisions they otherwise would have to take for credit losses, with such reduction directly attributable to expected recoveries on their credit enhancement protections.[3] Given the collateralized nature of the majority of the CRT purchased, the Enterprises have successfully reduced the systemic risk to the taxpayer that the current market environment has posed.

Observations and Proposal regarding the Leverage Ratio

Question 4: Is the tier 1 leverage ratio requirement appropriately sized to serve as a credible backstop to the risk-based capital requirements?

The FHFA has introduced an additional 1.5% Prescribed Leverage Buffer Amount bringing the overall leverage ratio to 4%. As described by the FHFA in connection with the 2020 Proposed Rule, this 4% leverage ratio is intended to be analogous to the 5% leverage ratio required of Federal Home Loan Banks.[4] The substantial increase over the FHFA's own assessment in 2018 results in an oversized

[2] To our knowledge, the FHFA does not dispute these substantial benefits of CRT. As of the drafting of this submission, the FHFA's website continues to state: "In 2012, the [FHFA] initiated development of a credit risk transfer program intended **to reduce [Enterprises'] overall risk and, therefore, the risk they pose to taxpayers** while in conservatorship. Fannie Mae and Freddie Mac implemented their credit risk transfer programs in 2013 and now transfer to private investors a substantial amount of the credit risk the Enterprises assume in targeted loan acquisitions." https://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Credit-Risk-Transfer.aspx (emphasis added). The FHFA's most recent "scorecard" for CRT states: "The Enterprises have made significant progress toward fully integrating a credit risk transfer program into their business models." https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Progress-Report-4Q2019.pdf at p. 11. And, "[p]ursuing a broad portfolio of credit risk transfer transaction structures furthers FHFA's objectives of having the Enterprises diversify their investor base for credit risk transfers and being able to compare execution across different structures and market environments." *Id.* at 12. Reinsurance CRT is purchased from "a variety of highly-rated insurers, reinsurers, and reinsurer affiliates of mortgage insurers, which reduces counterparty, reimbursement, and correlation risk" because reinsurers "are often characterized by diversified lines of business, which helps mitigate the risk that the Enterprises' counterparties are correlated to housing market stress and would have increased claims at the same time the Enterprise themselves are under stress." *Id.* at p.13 and n.4.

[3] http://www.freddiemac.com/investors/financials/pdf/10q_2q20.pdf

[4] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20140408a.htm, https://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title12-section1426&num=0&edition=prelim

and counter-productive leverage ratio because it: (a) does not suitably take into account the differences between banks and the Enterprises; and (b) does not include any credit for CRT, therefore failing to reflect the real-world benefits of CRT in reducing the risk to the Enterprises. Although the FHFA asserts it has sized the leverage ratio to approximate that required of banks, if like-for-like standards are applied, a leverage ratio tailored to the Enterprises should be significantly lower than 4% for the following reasons:

1. The Enterprises' product is inherently less risky than bank products, particularly in the wake of the FHFA's efforts to reduce the Enterprises' exposure to their highest risk exposures, as evidenced by comparisons of calculated Risk-Weighted Assets, by comparison to market prices, and by comparisons of historical loss performance.

    - **Comparisons of Risk-Weighted Assets:** The FHFA's risk weight for the Enterprises' book of business as of 9/30/19 is 27.8% (it was 21% prior to the application of the 15% Minimum Risk-Weight Floor). This is less than half (and was approximately one third) of the average SIFI Banks risk weight of 60% at the end of FY'18.

      This comparison also holds under the Basel Framework. Under the Basel Framework, the risk weight for Whole Loans is 50% for banks and 20% for MBS carrying an Enterprise Credit Guarantee. As a result, the residual risk of credit losses to the Enterprise can be interpreted as at most 30%, which is consistent with the current FHFA risk weight prior to the application of the 15% Minimum Risk-Weight Floor.[5]

    - **Comparisons to market prices:** The FHFA-approved guarantee fees charged by the Enterprises to account for the credit risk they retain is less than 1/4th the price for a 30-year mortgage.[6] This is indicative of the lower level of risk retained by the Enterprises relative to Commercial Banks, reflecting both the lack of interest risk, which is match funded via MBS, and lower credit risk due to tighter underwriting standards.

[5] Basel III and the Impact on the American Homebuyer and the Mortgage Market https://www.fdic.gov/regulations/laws/federal/2012-ad-95-96-97/2012-ad-97_c_05-supp.pdf

[6] The prevailing 2018 FHFA Guarantee Fee Report indicates an average guarantee fee of 55 basis points (https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GFee-Report-2018.pdf). This is 23.3% of the 236 basis-point spread between Primary 30-YR fixed-rate mortgage (2.88% according to Freddie Mac Primary Mortgage Market Survey 8/6/20 http://www.freddiemac.com/pmms/) and the US 10 Year Treasury (0.52% on 8/6/20 https://www.cnbc.com/quotes/?symbol=US10Y).

- **Comparisons of historical loss performance:** As demonstrated by Fannie Mae's former Vice Chairman and CFO Tim Howard,[7] the Enterprises' historical credit-risk loss rates have been a fraction of bank loss rates for single family mortgages and for commercial bank loans over the past 30 years, including through the Global Financial Crisis. In fact, for the period of 1992 – 2019, the credit losses for Fannie Mae Single Family Mortgages were 1/6th that of US Commercial Bank loan portfolios. Even when focusing on the years during and following the financial crisis, between 2008 and 2019, this loss level was still 70% lower than those suffered by Commercial Bank loans.

2. Compared to banks varied and opaque products, the Enterprises essentially offer a single product, and that product is transparent and fully subject to FHFA oversight.

    - **The Enterprises provide loan guarantees**: They generally retain a single material risk. This contrasts with banks, and to the bank leverage ratio, which is designed to protect against three risks: interest rate risk, liquidity risk, and credit risk. For the Enterprises, the majority of interest rate and liquidity risk is eliminated via the matching of assets via mortgage securitization, leaving only credit risk remaining on the Enterprises' book. This limited exposure substantially reduces the like-for-like requirements that should be considered when tailoring the leverage ratio to the Enterprises.

    - **The Enterprises' risk is well understood:** The Enterprises benefit from a wealth of performance data generated during the 2008 financial crisis that provides insight into default risk and the FHFA and the Enterprises have invested substantial resources in better understanding their product over the last decade. As a result, the Enterprises inarguably have portfolios that are significantly more transparent to observe, and subsequently easier to regulate, than banks.

    - **FHFA oversight:** The FHFA oversees the totality of the assets guaranteed and risk-weight matrices the Enterprises use to address risk.

3. As the Urban Institute has calculated, the capital required by the leverage ratio exceeds the cumulative realized losses in the Global Financial Crisis, even though the Enterprises' business model and portfolio is now materially less risky. Indeed, the Dodd-Frank Act stress testing (DFAST) of the current portfolio by the Enterprises and FHFA shows that the capital required by the leverage ratio is oversized by a factor of four.

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[7] Timothy Howard, *Comment on FHFA May 2020 Re-Proposed Capital Framework For Fannie Mae And Freddie Mac* (July 12, 2020) https://www.fhfa.gov//SupervisionRegulation/Rules/Pages/Comment-Detail.aspx?CommentId=15548

Oversizing the leverage ratio relative to a suitable Risk-Based Capital framework will have material adverse impacts on risk-management decisions. As evidenced by the FHFA's acknowledgment that the leverage ratio will apply from day one, the leverage ratio ceases to act a backstop and will apply even in some of the most benign economic scenarios. When the leverage ratio does apply, two adverse incentives are created:

(A) The Enterprises will be penalized for, rather than encouraged to, spread risks to the private sector via CRT because they get no capital credit for CRT to offset the fixed obligations that arise from purchasing the product; and

(B) The Enterprises will be encouraged to take on additional risk to boost return on equity, because a leverage ratio does not differentiate upon the riskiness of the assets.

Question 23: Is the PLBA appropriately sized to backstop the PCCBA-adjusted risked-based capital requirements?

Simply put, the inclusion of the PLBA results in an oversized leverage ratio thereby making sensible risk management with CRT uneconomical to the Enterprises. As detailed above, our efforts to triangulate to the overall leverage ratio requirements for banks to establish a similar framework for the Enterprises indicate that a comparable leverage ratio would be 1/3rd of that figure for banks.

RenaissanceRe proposes that the FHFA return to the 2.5% leverage ratio it originally supported in 2018 via the elimination of the PLBA. This leverage ratio is, firstly, conservative enough to enable the Enterprises to comfortably trade through a crisis as evidenced by the publicly available analysis including results from Dodd Frank Stress Tests, think tanks including the Urban Institute, and private investors such as Pershing Square.[8] Secondly, the proposed 2.5% leverage ratio enables the Enterprises to maintain their existing guarantee-fee structure, while providing an expected return that would suitably incentivize investors to take the Enterprises out of conservatorship. This is supported by the FHFA's own request for input on guarantee fees submitted in 2014.[9]

Observations regarding Risk-Based Capital for Retained CRT

Apart from instances when a backstop leverage ratio applies, the capital requirements for the Enterprises will be determined by the application of a set of Risk-Based Capital calculations. These should be driven by the relative level of risk of different assets and, in the case of CRT, the real-world effect of the risks retained by the Enterprises. This has the regulatory virtue of ensuring the

[8] https://online.wsj.com/public/resources/documents/irasohnfinal2014.pdf

[9] https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/GfeeRFI060514F.pdf

Enterprises' capital rules incentivize prudent management of the Enterprises' risks and sources of capital.

Indeed, the 2020 Proposed Rule requires a very thorough set of Risk-Based Capital calculations, but then overlays two additional haircuts on CRT, neither of which is risk-sensitive or tailored to the underlying risk. In its description of the 2020 Proposed Rule, the FHFA states that this is an intended departure from capital neutrality.

The two haircuts act to diminish a significant portion of the capital relief from CRT. First, the 2020 Proposed Rule imposes a 10% Risk-Weight Floor on amounts retained after CRT. Second, the rule cuts the capital benefit of CRT by another arbitrary 10%, captioned as the Overall Effectiveness Adjustment. The FHFA's own analysis demonstrates that these two haircuts result in an immediate ~50% reduction (from $41.3 billion to $22.1 billion) to the capital benefit from CRT, compared to the result under the Risk-Based Capital rules alone.[10]

It is common ground that CRT is not the same as equity capital, and adjustments to reflect the basis risk introduced through the purchase of CRT are justified. However, a ~50% negative departure from the FHFA's own Risk-Based Capital calculations on the basis of haircuts that are not risk-sensitive prevents the Enterprises from using the most efficient forms of capital to reduce their overall risk profile. This is all the more true considering CRT is not a novel product being foisted onto the FHFA. Instead, CRT is something that was fostered by, and has been refined and proven to be effective by, the FHFA over the last eight years. Under close FHFA oversight, CRT has become an important tool for de-risking the Enterprises, for providing diverse sources of capital, and for reducing taxpayer exposure to losses from the Enterprises. Each structure has been reviewed by the FHFA and deemed effective in transferring credit risk. This is now imperilled by the 2020 Proposed Rule's departure from capital neutrality. Indeed, Fannie Mae has already suspended their plans for further CRT transactions as they evaluate the 2020 Proposed Rule, citing the reduced capital relief they would obtain.[11]

While the FHFA notes several limitations of CRT protection relative to equity capital, these all (1) fall well short of the kind of justification that ought to be required to support such a radical departure from risk-based capital and capital neutrality with such devasting consequence for the proven CRT tool; and (2) can all be addressed in ways that retain risk-sensitivity and the viability of CRT.

- **Fungibility:** While CRT recoveries cannot be transferred between reference pools, the FHFA scorecard was developed to "transfer a meaningful portion of credit risk on at least 90

[10] Fact Sheet: Re-Proposed Rule on Enterprise Capital
https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/FS.pdf

[11] https://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2020/q22020_release.pdf

percent of the unpaid principal balance (UPB) of newly acquired single-family mortgages in loan categories targeted for credit risk transfer".[12] This consistent transfer of credit risk to the CRT market ensures there is steady coverage and it therefore minimizes the basis risk that would be present if there were inconsistent purchases.

- **Fixed Obligations:** CRT does present a series of fixed obligations. However, the obligations naturally reduce over time during benign housing markets through principal reductions on the most risk-remote transactions making the product more cost effective. Should credit conditions deteriorate, the CRT structure includes several provisions that will prohibit further principal reductions to ensure that the maximum limit is available for recoveries. These fixed costs also guarantee there is funding present in collateralized trusts to ensure the systemic issues of non-recovery that plagued the CDS market will not re-occur.

- **Application towards Credit Risk:** While CRT only applies towards credit risk, credit risk is the most-important risk held by the Enterprises. The FHFA's own analysis demonstrates that operational and market risks are dwarfed by credit risk under the risk-based capital framework.

In exchange for the limitations of the reference pools, the fixed payment obligations, and the focus on, and affirmative coverage for, credit risk, CRT provides the Enterprises with substantially-more-cost-effective tail-risk protection than can be obtained from equity capital. CRT providers are sophisticated and singluarly focused on assuming credit risk, and their pricing directly reflects the risk of each transaction. Since the stated concerns of the FHFA can be addressed and managed in other ways, these benefits of CRT should not be sacrificed to the problematic, and risk-insensitive, haircuts in the 2020 Proposed Rule.

Primary Challenges with, and Proposal for, the Risk-Based Capital Haircuts

Question 67: Is the 10 percent prudential floor on the risk weight for a retained CRT exposure appropriately calibrated?

- **Challenge Number 1 - 10% Risk-Weight Floor**: The 10% Risk-Weight Floor is the single largest contributor to the reduction in the capital benefit for CRT. This excessively penalizes CRT transactions by substantially increasing the total amount of capital required for exposures for which the Enterprises have obtained effective risk transfer. It can have the effect of requiring the Enterprises to hold less capital for the risk of a first-dollar loss unprotected by CRT, than for the much-more-remote risk of a dollar of loss after exhaustion of CRT. Its structure is unfit for purpose in that the optimal Post-CRT Risk-Weighted Assets

[12] https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2019-Scorecard-12192018.pdf

can be achieved through a structure that exhausts slightly before the weighted average capital requirements. The Exhibit below highlights how this can create perverse incentives for the Enterprises to retain more risk. Using the FHFA's CRT Tool, we have created two identical layers on a standard CIRT Structure. Option A attaches at 20 basis points and detaches at 190 basis points. Option B detaches 400 basis points and attaches at the same 20 basis points. Although Option B clearly transfers significantly more risk to third parties, it perversely results in the Enterprise being required to hold more capital than Option A. This highlights that this haircut penalizes the capital relief of CRT in a manner that is disconnected from the economic reality and real-world benefits of CRT.

Generic CIRT Example

	Option A (170 x 20)	Option B (380 x 20)
$RWA_{\$}$	$ 300,000,000	$ 300,000,000
$AggUPB_{\$}$	$ 1,000,000,000	$ 1,000,000,000
$EL_{\$}$	$ 2,000,000	$ 2,000,000

CRT Tranches

	Parameter A	Parameter A
AH	1.90%	4.00%
M1	0.20%	0.20%
B	0.00%	0.00%

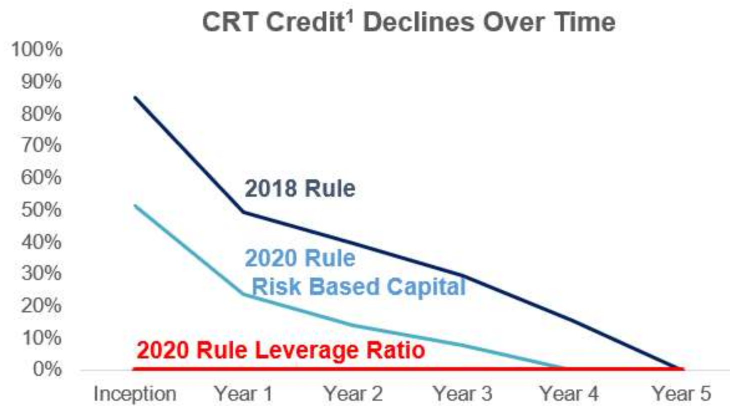
	Parameter D	Parameter D
AH	100.00%	100.00%
M1	1.90%	4.00%
B	0.20%	0.20%

Aggregate Post-CRT RWA and Capital Relief

	Option A	Option B
Total Post-CRT $RWA_{\$}$	$ 130,107,813	$ 156,473,217
RWA $Relief_{\$}$	$ 169,892,188	$ 143,526,783

- **Challenge Number 2 - Timing Impact of Risk-Weight Floor:** In an environment with increasing home prices, data shows that the capital benefit from CRT is not just reduced, but is totally eliminated within five years.[13]

[13] RAA/Guy Carpenter/Aon Analysis of Impact of Risk-Weight Floor



1 - CRT Credit = Capital Benefit from CRT / Remaining CRT Limit
Assumptions: 5% Annual Home Price Appreciation | 15% Annual Prepayments | 1 bp Annual Paid Losses

Proposal to suitably address Risk-Based Capital: Given these unjustified capital impacts are directly at odds with economic reality, it would better serve FHFA's overall goals to eliminate the 10% Risk-Weight Floor. However, recognizing the FHFA's stated concerns about model miss on specific transactions, a more appropriate course of action would be for the FHFA to apply a risk-weight floor to a portion of the retained AH Tranche that could be reasonably subject to loss in a severely-stressed event, with nil retention above this additional buffer. As such, we propose for the 10% Risk-Weight Floor to be applied for retained CRT when it is within 1.5x the Weighted-Average Capital Requirements. This application would have two material benefits to the Enterprises. Firstly, it incentivizes the purchase of CRT to a suitable level above the Risk-Weighted Assets, highlighting that there can be more risk to an individual transaction than equity required capital would imply. Secondly, it would dynamically adjust as risk reduces through home price appreciation and amortization, rather than the existing form which does not recognize any difference in risk as the underlying loans season. This is in line with the standard exhaustion points of recently purchased CRT transactions and therefore is a reasonable estimate of where the Enterprise risk-management teams have thought of as a prudent purchase.

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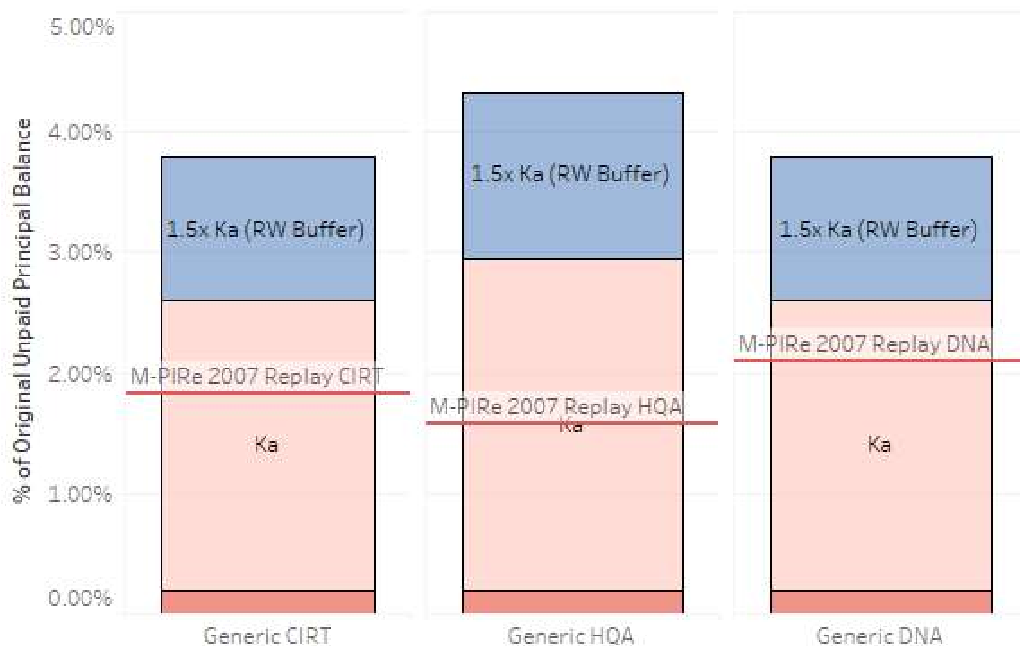
Exhibit: Graphical representation of portion of UPB that would be subject to 10% Risk-Weight Floor. The red line in each bar indicates the Milliman analysis of Loss Rates to a 2020 reference pool from a 2007 stress replay.



Question 73: Is the 10 percent adjustment for the general effectiveness of CRT appropriately calibrated?

- **10% Overall Effectiveness Adjustment:** This is a material departure from risk-based capital and capital neutrality that creates a further deterrent to the effective transfer of risk. The FHFA's concerns are better managed with more risk-sensitive tools, indeed many of these tools have been refined by the FHFA over the eight-year development of the CRT program and are specifically tailored to the characteristics and trade-offs of CRT. For example, the Enterprises must convince the FHFA that the terms and structure of a CRT contract are effective in transferring credit risk to receive credit. Furthermore, to suitably account for the perceived lack of fungibility of CRT and other constraints of the structure, the FHFA has already established several haircuts that are specifically tailored to the risk. Of course, the FHFA retains the ability to make further adjustments going forward, but its proposed 10% Overall Effectiveness Adjustment would be redundant and counter-productive. Accordingly, our proposal is for the FHFA to eliminate the newly introduced Overall Effectiveness Adjustment.

A notable concern from those who do not support the use of CRT as a risk-reducing mechanism is an environment whereby the Enterprises arbitrage the capital framework to remove the majority of equity capital in a manner that doesn't efficiently protect the shareholder and, ultimately, the taxpayer. However, there are two factors that materially mitigate this risk. Firstly, the Enterprises face numerous additional, non-risk based, buffers that ensure substantial equity capital is held. These include: (a) the Stress and Stability Capital Buffers, and (b) a Leverage Ratio as a backstop. The presence of these buffers renders the additional haircuts on retained CRT redundant and counter-productive. In a hypothetical environment where every transaction is fully covered by collateralized CRT (providing 100% capital relief) and the leverage ratio is eliminated, the Enterprises would still be required to hold Equity for 1.63% of Adjusted Total Assets due to the Stress and Stability Buffers. In reality, CRT will not receive 100% capital relief, thus ensuring the minimum equity held will remain the substantial form of capitalization for the Enterprises. Secondly, there is a significant independent backstop preventing arbitrage of capital standards for the Enterprises when using reinsurance for CRT. Under both IFRS and GAAP accounting standards, a transaction must pass an externally audited risk-transfer test in order to receive reinsurance accounting and therefore be included within underwriting results. In the absence of demonstrable proof of risk transfer, the transaction is considered a financial instrument and categorized under deposit accounting. This ensures there are suitable checks and balances from the counterparties in CRT transactions to promote sustainable products that successfully de-risk the Enterprises.

As noted above, we propose that the FHFA replace the 10% Risk-Weight Floor for retained CRT with a risk-based measure and propose the removal of the 10% Overall Effectiveness Adjustment. We would be willing to provide additional feedback on the suitability of the existing haircuts on retained CRT but believe the FHFA has done an effective job thus far in quantifying the impact of counterparty and loss timing risk.

Impacts of Disincentivizing CRT

The undermining of CRT by the 2020 Proposed Rule will have negative consequences for the Enterprises, the US taxpayer, and the broader housing-finance market. These consequences mirror the reasons that the FHFA has been encouraging the use of CRT for the last eight years:

- **Re-concentration of risk in the Enterprises**: Increasing the leverage ratio from 2.5% to 4% introduces an environment in which the capital benefit of CRT is either zero at inception when the leverage ratio applies or unknown when the leverage ratio does not apply, but very well might apply sometime over the life of the CRT. Regardless, the Enterprises would still be required to fulfill contractual premium obligations under the CRT contract. Because this capital treatment diverges from economic reality, shareholders will encourage the Enterprises to retain credit risk, rather than transfer it to private markets, as it will be dilutive to their returns during periods of low risk weights.

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- **Higher volatility, lower return on equity, higher mortgage costs, and a more difficult exit from conservatorship**: The FHFA's current proposal dramatically increases the level of capital the Enterprises are required to hold while simultaneously discouraging the purchase of CRT to transfer risk and reduce volatility. Under the FHFA's own analysis in 2013, a capital requirement of 400 basis points would result in a minimum required guarantee fee ("G-Fee") of 76 basis points to provide a 9% after-tax return. This is before considering the increased fees necessary to support this business in an environment with a higher Risk-Based Capital requirement. The resulting increased fees would be passed directly to the homeowner, resulting in an expected additional annual cost of approximately $475 on $250,000 of unpaid principal balance. Over the lifetime of the loan this would amount to a $10,000 tax on the homeowner. Even then, it is far from clear that the Enterprises — with a more volatile, CRT-deprived, business model — will be able to raise the equity capital contemplated under the 2020 Proposed Rule to exit conservatorship, which is approximately 10 times greater than the largest IPO ever, anywhere.

Illustrative G-Fee Computation
Source: FHFA 2014 Request for Input on G-Fees

Capital Requirement (Basis Points)	265	400*	500
Total Required G Fee (9% Return)	55	76	90
Lifetime Payment Increase ($250k Mortgage)	nil	$10,000	$17,000

*400 Basis Points = Current Minimum Capital Requirement

- **Harm to the Enterprises' mission of supporting mortgage finance during periods of economic stress:** The current economic crisis demonstrates the importance of stable mortgage finance during periods of economic stress. Credit availability during March and April 2020 tightened dramatically for mortgage classes apart from conforming loans guaranteed by the Enterprises. The Enterprises' mission to provide support through all economic conditions provides a fundamental backstop to the mortgage market and the US economy as a result. The limitations introduced under the current proposal, including haircuts to CRT and the Stability Capital Buffer directly hamper the Enterprises' ability to respond effectively to a crisis. As the FHFA has explained, CRT supports this mission because it provides a diverse source of uncorrelated capital. Furthermore, the collateralized nature of much of the CRT exposure provides material security and ensures an ability to pay during times of heightened stress. CRT demonstrated its resiliency through this most recent crisis and was the first market to re-open to mortgage risk. NMI Holdings, a leading US PMI, was the first to raise additional capital following the Covid-19 crisis, in the form of a

reinsurance quota-share transaction. This successful reinsurance transaction preceded and supported their ability to raise additional debt and equity in the capital markets.[14][15]

- **A less liquid and subsequently less resilient housing finance market:** The FHA and Fannie Mae were created in the wake of the Great Depression specifically to create liquidity in the mortgage market.[16] Today, Enterprise-guaranteed securitizations of mortgage portfolios trade in the highly-liquid TBA ("To Be Announced") Market, in which the Enterprises play an essential role.[17] The forward nature of the TBA market aids in the ability of lenders to lock-in mortgage rates, which in turn provides lower and more stable rates for borrowers. Unnecessarily increasing the capital costs and guarantee fees of the Enterprises will fragment the market, which would reduce the homogeneous nature of these securities and result in increased trading costs. Research from the New York Fed shows the TBA market provides a benefit for mortgage-security yields in the amount of 10 to 25 basis points. Disrupting that market will have meaningful negative consequences.[18] The support of the Enterprises' mission for sustainable housing finance through the economic cycle has proven exceptionally important in the current crisis where credit availability for non-conforming loans in the private sector have dropped significantly. The Enterprises' activities in recent months have enabled the US housing market to help support the US economy through this recent crisis, rather than being a drag on the potential for economic recovery.

- **Less effective Enterprises and increased risk to the taxpayer:** The oversized capital requirements, perverse incentives, and lack of CRT all tend towards Enterprises that are simultaneously (a) smaller and less able to serve their mission, but also (b) more, rather than less, risky. Further, making the Enterprises less competitive will push business further to entities such as the FHA, which presents an even-more-direct exposure to the American taxpayer.

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[14] https://ir.nationalmi.com/news-releases/news-release-details/nmi-holdings-inc-enters-new-quota-share-reinsurance-arrangement

[15] https://www.globenewswire.com/news-release/2020/06/05/2044412/0/en/NMI-Holdings-Inc-Increases-Size-of-Offering-and-Prices-400-million-Senior-Secured-Notes-Due-2025.html

[16] FHFA: A Brief History of the Housing Government-Sponsored Enterprises https://www.fhfaoig.gov/Content/Files/History%20of%20the%20Government%20Sponsored%20Enterprises.pdf

[17] BI Analyst Briefing: Fannie Mae/Freddie Mac and Mortgage Market Outlook https://beacon360.content.online/xbcs/S1245/catalog/product.xhtml?eid=21920

[18] TBA Trading and Liquidity in the Agency MBS Market https://www.newyorkfed.org/research/epr/2013/exesum_vick.html

- **Removal of an independent source of underwriting discipline:** CRT participants, because they genuinely take and hold risk from the Enterprises, form their own views about the risks presented. Reinsurers, for example, utilize their own models and must demonstrate that risk is transferred to satisfy their own regulatory and accounting requirements. As shown in comments presented by Milliman, the benefit of this independent source of underwriting discipline was demonstrated in 2018 and 2019, when pushback from CRT providers dissuaded the Enterprises from continuing with relaxing standards permitting riskier high debt-to-income ("DTI") loans.[19] The removal of risk overlays for >45% DTI loans was the first meaningful loosening to underwriting standards by the Enterprises since the Global Financial Crisis. Concentration levels of >45% DTI loans in Enterprise pools increased from 5-10% to 20-25% as a result of the removal of these risk overlays. CRT participants, along with the US PMIs, quickly reacted to this market dynamic by reaching out to the Enterprises to work with them on reigning in these >45% DTI concentrations. This "feedback loop" from CRT participants to the Enterprises serves as a useful second set of eyes on any changes to underwriting standards and is an effective tool to prevent the Enterprises from creeping back toward pre-Global Financial Crisis underwriting standards.

[19] Milliman, *Response to FHFA Proposal Capital Framework Treatment of Credit Risk Transfer Securities and Reinsurance*, available at FHFA.gov

Summary of Proposals

As noted in our commentary, we propose three critical changes to the 2020 Proposed Rule to better enable the Enterprises to manage their capital in a manner that is consistent with sound risk-management principles. We agree with the goals of the FHFA's proposal but conclude that there will be several meaningful unintended consequences to the CRT market, to the Enterprises' ability to raise equity, to housing market stakeholders, and to taxpayers. As such, we respectfully propose the FHFA consider the following amendments to the 2020 Proposed Rule:

- Restoration of the leverage ratio to the 2.5% level set by the FHFA in its original 2018 proposal, being 2.5% of Adjusted Total Assets.
- Removal of the 10% Risk-Weight Floor for Retained CRT. This is to be replaced with a 10% Risk-Weight Floor on retained exposure within 1.5x of the Weighted-Average Capital requirements of the underlying exposure for the Transaction.
- Removal of the 10% Overall Effectiveness Adjustment.

Respectfully submitted,

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