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Alfred M. Pollard  
General Counsel  
Federal Housing Finance Agency  
Eighth Floor  
400 Seventh Street, SW  
Washington, DC 20219  
Submitted at <http://www.regulations.gov>

Re: Enterprise Regulatory Capital Framework; RIN 2590-AA95

Dear Mr. Pollard:

The Federal Housing Finance Agency's ("FHFA's") Re-Proposed Rule on Enterprise Capital, release on May 20, 2020<sup>1</sup> (the "2020 Rule") is a significant and important development in the regulation of the U.S. mortgage market and is foundational to resolving the conservatorships of Fannie Mae and Freddie Mac (the "Enterprises" or "GSEs"), and to the health of housing finance markets for years to come. The FHFA thoughtfully modified the 2020 Rule based on the comments provided by Arch and other stakeholders in response to the original Enterprise Capital Rule released by FHFA in 2018<sup>2</sup> (the "2018 Rule"). Arch Capital Group Ltd., on behalf of itself and its affiliates ("Arch"), recognizes the substantial effort required to publish this framework, and appreciates the FHFA's willingness to work collaboratively with industry stakeholders to incorporate important feedback on aspects of the 2020 Rule.

Arch is a leading insurance organization, and through its insurance subsidiaries, provides commercial, institutional and individual customers with mortgage, property-casualty, and reinsurance offerings on a worldwide basis. Arch has made a long-term strategic commitment to the U.S. mortgage market, investing in, managing and distributing credit risk in a variety of single family and multifamily executions, and has contributed to deepening and diversifying the base of capital and expertise in U.S. mortgage credit risk to the benefit of consumers, taxpayers, and the general economy. As a leading provider of private mortgage insurance in the United States with \$276 billion of insurance in-force as of June 30, 2020, and an active participant and innovator in credit risk transfer ("CRT") programs, Arch has

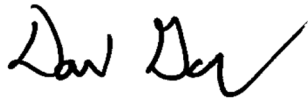
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<sup>1</sup> 85 Fed. Reg. 39274 (June 30, 2020).

<sup>2</sup> 83 Fed. Reg. 33312 (July 17, 2018).

developed its own internal credit risk and econometric models and invests heavily in the intellectual capital required to support underwriting decisions and risk management. Thus, Arch is well-positioned to provide input on the proposed rule.

Sincerely,

A handwritten signature in black ink, appearing to read "David Gansberg". The signature is fluid and cursive, with a prominent initial "D" and a checkmark-like flourish at the end.

David Gansberg

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## 1. Executive Summary

The FHFA stated three primary objectives when re-proposing the 2020 Rule, which are to:

1. Preserve the mortgage risk-sensitive framework of the 2018 Rule;
2. Increase the quantity and quality of the regulatory capital of the Enterprises to ensure that each Enterprise is positioned to provide stability and ongoing assistance to the secondary mortgage market across the economic cycle; and
3. Address the pro-cyclicality of the risk-based capital requirements.<sup>1</sup>

In Arch's opinion, the FHFA has made significant enhancements to the 2018 Rule and has addressed two of its stated objectives. The FHFA has achieved its third objective and meaningfully addressed the pro-cyclicality of the risk-based capital requirements. As Arch proposed in its comment letter submitted in responses to the 2018 Rule, the proposed countercyclical adjustment increases required capital when home prices are overvalued and decreases capital when home prices are undervalued by more than 5%. The buffer is assessed at the portfolio level and the capital assessment is gradual over time. So long as the Enterprises have a nationally diversified footprint, a nationally assessed buffer may suffice; however, Arch believes a state or MSA-level assessment would further reduce procyclicality by addressing U.S. housing market heterogeneity. The FHFA has also partially achieved its second objective by setting forth a reasonable proposal with respect to the quantity and quality of capital. In particular, the FHFA significantly improves the quality of capital by creating supplemental regulatory capital definitions that address shortcomings in the statutory definitions.

Arch also commends the FHFA on the favorable treatment for loan level mortgage insurance ("MI") within the rule, which is appropriate given the significantly improved risk management practices and counterparty strength of current private mortgage insurers. The industry has employed enhanced risk management practices such as risk-based pricing which allows risk to be appropriately priced without cross subsidization, and programmatic risk transfer through issuance of mortgage insurance linked notes (MILNs) and reinsurance to manage risk aggregations and volatility of capital needs during severe stress events. Arch notes that MILNs utilize similar structures and characteristics as the programs employed by GSEs and firmly believes these tools are critical to managing downside CAT events. The MI industry is well positioned to be a reliable source of capital for the GSEs and the housing finance sector more broadly.

However, in Arch's opinion, the FHFA falls short of achieving its first objective of preserving the risk-sensitive framework of the 2018 Rule. As a result, the 2020 Rule is poised to fundamentally return the GSEs' business model to its pre-crisis form (albeit with higher capital levels), in which the GSEs are inadequately incentivized to mind and manage the accumulation of credit risks on balance sheets that remain taxpayer-backed. The levels of risk-insensitive capital required, the inability to reduce such amounts through CRT, and the resulting increased guarantee fees ("Gfees") levied to cover the increased required capital, will render the GSEs uncompetitive during periods of benign credit for all but the riskiest loans. The GSEs footprint will dramatically shrink in good economic times, and due to the limitations contained in their Congressional charters that prevent the Enterprises

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<sup>1</sup> 85 Fed. Reg. 39275 (June 30, 2020).

from expanding into ancillary businesses like banks do<sup>2</sup>, the GSEs will be limited to increasing the riskiness of their loan portfolios and increasing fees to maximize returns. This business model begs the questions of: 1) whether private capital investors will be willing to invest the substantial equity capital needed for the GSEs to exit conservatorship, or willing to continue deploying high-quality private capital to the housing finance system, and 2) whether the GSEs will be able to continue providing stability during periods of stress and illiquid private markets. If the 2020 Rule is enacted as drafted, in Arch's opinion, the answer to both questions is no.

Substantial private capital participation of the U.S. housing market is of paramount importance to responsibly expanding credit availability and housing opportunities for Americans. However, this important objective must be balanced with the statutory purposes of the GSEs as defined by Congress, which include providing market stability and liquidity, access to low- and moderate-income families, and access to credit across the nation. GSE participation across the credit risk spectrum and across economic cycles is critical to both attracting substantial lasting equity investment in the U.S. housing market and maintaining the safety and soundness of the GSEs to provide stability to the housing market during times of stress. Fortunately, with only a few adjustments Arch believes that the FHFA can achieve a capital requirement that maintains safety and soundness of the GSEs, while also preserving and encouraging further substantial private capital investment into the U.S. housing finance market. Arch's comments and suggested revisions to the 2020 Rule are offered in the spirit of balancing these two important concerns and can be summarized as follows:

- The cumulative reductions of credit applied to credit risk transfer are too punitive, so Arch recommends the 10% risk-weight floor applicable to the senior most tranche be eliminated;
- The proportion of risk insensitive buffer capital is too high and should be reduced and adjusted to be more risk sensitive;
- The Leverage Ratio is overly conservative and should be reduced;
- The final rule should give FHFA the authority to base the countercyclical adjustment on a state or MSA-level as required to respond to housing finance reform outcomes;
- The assignment of counterparty ratings and the determination of mortgage concentration are opaque and should be more transparent; and
- The multifamily capital requirement should be adjusted to reduce procyclicality, and the loss timing adjustment to multifamily CRT credit should be refined.

The remainder of this letter provides further explanation and analytical support underlying Arch's recommended modifications.

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<sup>2</sup> The GSEs are prohibited by their charters from originating loans or lending directly to consumer, and further must obtain prior approval before deploying any new programs. See FEDERAL NATIONAL MORTGAGE ASSOCIATION CHARTER ACT. Title III of National Housing Act, 12 U.S.C. 1716 et seq. and FEDERAL HOME LOAN MORTGAGE CORPORATION ACT Public Law No. 91-351, 84 Stat. 450.

## 2. Increase Credit for CRT in the Risk-Based Capital Calculation

### 2.1. The Benefits of CRT

Before commenting on the capital relief afforded CRT under the 2020 Rule, it is worth reflecting on the significant benefits that CRT has provided and continues to provide the Enterprises.

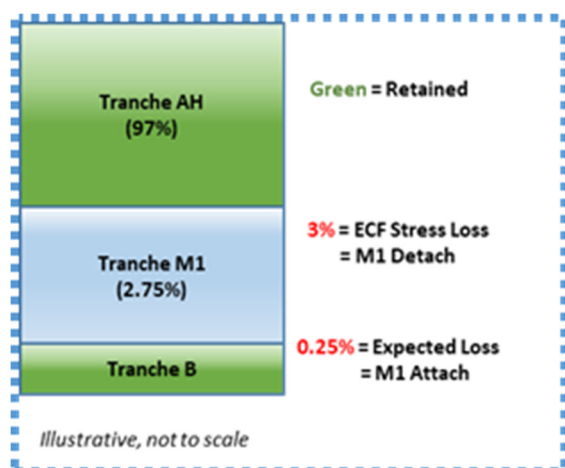
- Tail risk management: The CRT transactions are typically structured to cede all unexpected stress losses (as defined and calibrated by the 2018 Rule) to the CRT investor. This stabilizes the earnings profile of the Enterprises and significantly reduces taxpayer exposure to another downturn in the U.S. housing market.
- Lower costs of capital: The CRT transactions are typically structured with a first loss layer retained by the Enterprises, structures are separated into tranches, and there is an active secondary market. These features have attracted a diverse investor base and, as a result, the cost of CRT capital is significantly below the cost of equity capital required by a private market investor for this type of risk. Borrowers benefit from efficient use of diverse capital sources that lower the Gfee costs.
- Feedback loop: This diverse investor base also provides feedback to the GSEs on credit costs and on underwriting standards. A good example of the latter occurred in 2018 when the Enterprises relaxed debt-to-income (“DTI”) thresholds. CRT investors quickly identified the increased risk, and their feedback heavily influenced the Enterprises’ decision to reconsider and adopt a more prudent approach. Arch believes this feedback loop acts in a countercyclical manner in that this feedback will be loudest when credit standards are deteriorating.

The CRT program has been viewed, almost universally across the industry, stakeholders and the policymaking community as a huge success since the inaugural transactions in 2013. Since that time a wealth of infrastructure and market expertise has been developed by private markets to analyze and price mortgage credit risk, much to the benefit of market stability. The Enterprises have successfully expanded the stable of CRT investors and have deployed new and innovative forms of transactions that directly contribute to the broader distribution of credit risk in the financial system. The diversity of market participants that invest in CRT transactions is a real strength of the program in that each investor type provides differing, yet valuable benefits to the GSEs and FHFA. Since the financial crisis and the GSEs’ programmatic use of CRT, multiline reinsurers are investing more heavily in mortgage credit risk than ever before. Reinsurers, similar to private mortgage insurers, provide a stable source of capital and a long-term independent view of credit risk and loan performance. Without this feedback loop, policymakers and the Enterprises themselves would be deprived of important market feedback on the riskiness of the loans the Enterprises are acquiring. Reinsurers can also provide coverage to cover loans acquired by the GSEs in the future, which is known in the industry as a forward commitment. Forward commitments mitigate the procyclical risk that CRT protection will not be available during periods of market stress. Capital market participants, on the other hand, typically invest in shorter term securities. However, the shorter duration and the liquidity of the secondary market often result in a lower cost to the GSEs at certain points of the economic cycle. Finally, the GSEs have executed several alternative forms of CRT, including lender risk-sharing transactions and investor-placed mortgage insurance, to name but a couple. Alternative forms of CRT expand the channels for distributing risk from the Enterprises’, expands the pool of private capital capable of investing, and should be encouraged.

However, Arch believes the 2020 Rule puts the CRT program and all its benefits in jeopardy. Illustrating this point, in a July report Fannie Mae filed with the U.S. Securities and Exchange Commission, it stated that the Enterprise “currently [does] not have plans to engage in additional credit risk transfer transactions as [it] evaluate[s] FHFA’s recently re-proposed capital rule, which would reduce the amount of capital relief [it] obtain[s] from these transactions.”<sup>3</sup> In the midst of some of the most uncertain economic conditions ever faced in the U.S., the CRT market is still active and willing to price for and accept the economic risk (Freddie Mac and the MI companies are still executing transactions with the private market). The fact that Fannie Mae has ceased its CRT program is a very unfortunate but timely example of the perverse and costly consequences of the 2020 Rule.

## 2.2. The Collective CRT Haircuts are Redundant and Needlessly Punitive

Credit for CRT under the 2020 Rule has been reduced by over half compared to the credit recognized under the 2018 Rule, which can be attributed to the application of a 10% tranche floor (including on the tranche above stress losses, sometimes named the “AH” tranche) and the three effectiveness adjustments. As currently proposed, the reduced credit significantly reduces the incentive for the GSEs to continue to cede risk to private capital through CRT transactions, even when the Leverage Ratio is not the binding constraint.



Consider the stylized example where the GSE fully retains expected losses (25bps) in the “B” tranche; cedes 100% of a single “M1” layer which detaches at the 2020 Rule (or “ECF”) stress losses associated with the underlying loans (300bps), and retains the remaining “AH” tranche. Without any haircuts, the capital ceded would be 275bps, which is 100% of the M1 tranche.<sup>4</sup>

To determine CRT credit under the 2020 Rule, the GSE would first calculate the risk weights for each tranche assuming full effectiveness of the CRT in transferring credit risk on the underlying mortgage exposures. In general, tranche risk weights are the highest for the riskiest, most junior tranche (such as tranche B) and lower for the more senior tranches (such as tranche M1). The AH tranche represents the risk retained by the GSEs above the detachment point of the structure. In this example, the detachment point of 300 bps is set to cover stress losses akin to the losses suffered in the 2008 financial crisis. Hence, the retained risk in the AH layer consists of highly improbable tail losses from the remaining 97% of risk associated with the pool of loans. The application of the 10% minimum risk weight floor on the AH tranche in this stylized example reduces the capital ceded by 78 bps (= 97% tranche size \* 10% risk weight floor \* 8% capital charge) to 197 bps (275 bps – 78 bps), and results in 72% = 197 / 275 capital credit at inception for the M1 tranche.

<sup>3</sup> <https://www.sec.gov/Archives/edgar/data/0000310522/000031052220000278/fnm-20200630.htm>

<sup>4</sup> The chart illustrates the stylized example but is not drawn to scale.

Next, the Enterprise would apply the three effectiveness adjustments, which are reflected in the Enterprise's adjusted exposure amount.

- The Overall Effectiveness Adjustment (OEA) increases the GSE's retained exposure to reflect that CRT transactions may not provide the same flexibility, fungibility, and loss-absorbing capacity as equity capital. The application of the OEA is accomplished by applying a 10% haircut to any risk ceded. The capital ceded in our stylized example is reduced by a further 27.5 bps to 170 bps, or 62% of the M1 tranche.
- The Loss Timing Effectiveness Adjustment (LTEA) increases retained exposure to reflect the mismatch between lifetime losses on the underlying 30-year fixed-rate single-family mortgage exposures and the duration of the CRT's coverage. For a typical 12.5 year deal, the LTEA reduces the capital ceded by a further 7% haircut. The capital ceded is reduced ~19 bps to 151bps, or 55% of the M1 tranche.
- The Loss Sharing Effectiveness Adjustment (LSEA) increases retained exposure from uncollateralized risk-in-force. Assuming 20% collateral and an 11.4% counterparty haircut<sup>5</sup> on uncollateralized balances, at the time of inception, the LSEA results in a further 7.6% haircut. The capital ceded is reduced by a further ~21 bps to 130 bps, or 47% of the M1 tranche.

Assuming 3% annualized home price appreciation and 10% conditional prepayment rate, the table below outlines the percentage of initial CRT limit obtaining capital credit, for this same stylized example, through the first five years of the CRT transaction. This example assumes an average mark-to-market loan-to-value ("MTMLTV") at inception of 90%, and for simplicity, excludes the MI counterparty charge.

Scenario Description	Time (yrs)							Avg.
	0	1	2	3	4	5		
No CRT haircuts	100%	78%	60%	44%	31%	19%	67%	
Incl. CRT Tranche Floor..	72%	53%	38%	24%	13%	3%	40%	
..and OEA	62%	45%	31%	20%	9%	1%	34%	
..and LTEA	55%	40%	27%	16%	7%	0%	29%	
..and LSEA* =2020 Rule	47%	34%	23%	14%	6%	0%	25%	
Arch Proposal (excl. Tranche Floor)	76%	60%	46%	34%	24%	15%	51%	
2018 rule = LTEA/LSEA only	84%	66%	51%	38%	27%	17%	57%	

At inception (or time = 0), the results reflect the relevant numbers associated with the application of the risk weight floor and effectiveness adjustments described above. Comparing the 2020 and 2018 rule in the table above, CRT capital relief at inception reduces from 84% to 47%. Over the 5 years, annualized capital relief

<sup>5</sup> Assumes an A+ rated multiline reinsurer, without high concentration in mortgage, rated as a 4, per the proposed single-family CP haircuts, from Table 21.



reduces from 57% to 25% - i.e. more than cut in half. Because of this, and all else equal, the GSE's ceded cost of capital from CRT more than doubles and the incentive to continue ceding risk to private market participants is significantly reduced. While Arch agrees that the capital requirements should be reasonably conservative to reflect uncertainty around fungibility, loss timing, and counterparty risks, the compounding effects of these adjustments with the addition of a CRT tranche floor adds unnecessary conservatism. The cumulative adjustments applied to CRT are also more punitive than the adjustments applied to loan level coverage provided by private mortgage insurers. By and large, Arch believes that the credit for coverage provided by private mortgage insurers is reasonable, and that it provides a framework that the FHFA should consider when equivalent protection is provided by other CRT providers (i.e. by strong multiline reinsurers).

### **2.3. Eliminate the 10% Tranche Floor on the AH Layer**

Arch recommends that FHFA enhance CRT credit by eliminating the 10% tranche floor on the AH layer as it is not analytically supported. The three effectiveness adjustments are based on sound economic rationale, and Arch agrees that implementing such adjustments are appropriate to address legitimate concerns regarding the lack of fungibility of CRT capital outside of the defined structure, timing mismatch between lifetime losses and CRTs coverage, risk associated with uncollateralized reinsurance and model error. The 10% tranche floor seems to be an unnecessary haircut intended to add conservatism to address the same risks that the effectiveness adjustments already address. In Arch's view, the three effectiveness adjustments add significant conservatism compared to the estimated benefit the Enterprises' would realize to cover stress losses and more than adequately address FHFA's concern that the CRT capital does not provide the same loss-absorbing capacity as regulatory capital.

Moreover, consider the distribution of losses that would flow to the AH tranche, which covers the 97% of retained exposure above the 3% detachment point in the stylized example detailed in Section 2.2. Since the M1 tranche is structured to cover stress losses akin to the 2008 financial crisis, the losses that pierce the AH layer would be very remote. Indisputably, every loan in the underlying pool will not suffer losses, yet the 10% tranche floor applies to the entire 97% of risk retained in the AH layer. While the risk above the proposed rule stress losses is not risk-free, since there is some model risk, the 10% floor is unnecessary to address such a remote risk of loss. Removing the tranche floor will allow FHFA to accomplish its goal of implementing a reasonably conservative capital standard, while maintaining the incentive for a GSE to responsibly manage its risk aggregations by ceding credit to private market participants.

### **2.4. The Recent Market Disruption Demonstrates Continued Market Participation**

The disruption in the CRT markets during the recent COVID-19-related financial stress has given rise to concerns related to the availability of certain markets through the economic cycle. All in, the CRT markets were unavailable for new issuances for approximately 90 days, while secondary market for trading existing securities were only unavailable for 30 days. The market disruption was relatively short despite the material changes in economic conditions and substantial uncertainty as a result of the pandemic and the evolving government response related thereto (including the impact of the forbearance relief provided by Congress under the CARES Act<sup>6</sup>). Some of the disruption might have been driven in part by leveraged market participants that had invested in CRT rapidly de-

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<sup>6</sup> Coronavirus Aid, Relief, and Economic Security Act, Pub. L. 116-136 (2020).

levering when confronted by margin calls on short-term financing. However, the main driver of the 90-day pause was caused by investors analyzing their economic assumptions and repricing based on the increased risk in the market. As another point of reference, during the 2008 financial crisis, the capital markets stopped trading for a period of about 90 days, again the markets paused to analyze the uncertainty from new economic conditions, an uncertain and evolving policy response, and to reset price expectations. These two examples demonstrate that investors do return, after repricing the risk, and in no way diminishes the value of existing placements. Re-pricing by investors in mortgage credit risk provides valuable feedback to both the GSEs and FHFA as it provides an independent view of market risk.

### **2.5. CRT Can Be Restructured to Remedy Structural Weaknesses**

Justifying the reduction in credit for CRT under the 2020 Rule, FHFA cites that “securitization structures, especially complex securitizations, might not perform as expected during a financial stress” and that structural defects could “further limit the effectiveness of CRT in transferring credit risk.”<sup>7</sup> Since 2013, the Enterprises have made adjustments to CRT structures in the ordinary course to address perceived short comings of existing structures. If FHFA believes that structural defects remain or that contractual protections are inadequate, then FHFA should direct the Enterprises to modify the terms for new transactions on a prospective basis under its existing authority, rather than broadly discounting all CRT structures.

### **2.6. Credit for Prior CRT Transaction Should Be Based on the Rules in Effect at Inception**

Applying the new capital rule retroactively will immediately render prior CRT transactions inefficient and will disincentivize the issuance of new CRT transactions before this rule is finalized. Part of Fannie Mae’s decision to halt its CRT programs was the retroactive imposition of the 2020 Rule to transactions designed for capital optimization under the 2018 Rule. Altering prudential rules retroactively will limit investor interest in the GSEs out of conservatorship, as the return expectation could change materially based on the new rules. In addition, retroactively decreasing CRT credit could result in the GSEs utilizing or expanding their use of regulatory call options, which adds to the regulatory uncertainty that investors will need to price for. Therefore, Arch recommends that FHFA apply the 2020 Rule prospectively, and that credit for prior CRT transactions be calculated based on the rules in place at the inception of the transaction in this instance, and as a matter of principle, in any future changes to the capital standards.

## **3. Adjust the Leverage Ratio**

As FHFA noted in the preamble of the 2020 Rule, the Leverage Ratio is intended to provide a credible backstop and going-concern capital adequacy standard to ensure that each Enterprise will be positioned to fulfill its statutory mission to provide stability and ongoing assistance to the secondary mortgage market across the economic cycle. Arch agrees with FHFA that a strong Leverage Ratio is necessary to ensure the Enterprises hold sufficient minimum capital but notes that setting the Leverage Ratio too high will result in significant unfavorable outcomes that could undermine the purpose of the Leverage Ratio. Instead of reducing risk to the Enterprises, an excessively high leverage requirement that regularly surpasses risk-based capital requirements in frequency and

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<sup>7</sup> 85 Fed. Reg. 39330 (June 30, 2020).

magnitude could encourage the Enterprises to forgo lower-risk assets in favor of those with higher-risks because the same capital requirement would apply for either asset. In addition, at times when the minimum leverage requirement is the binding constraint, an Enterprise may choose to reduce or halt its CRT program. As a result, the Enterprises will be incented to return to the pre-2008 financial crisis business model – underpricing risky business because the marginal capital requirement (the leverage ratio) is less than the risk-based requirement and not transferring risk, thereby becoming more concentrated in higher-risk mortgage credit.

The buy and hold business model failed once, and in Arch’s opinion will fail again, despite the high Leverage Ratio. During benign economic periods, the Enterprises’ footprint in low and moderate risk loans will dramatically shrink as those assets will be more efficiently executed by the private markets. While private markets have not yet demonstrated an efficient and seamless way to fully replace GSE capacity, in part due to unlevel regulatory impediments for alternative execution to the GSEs, Arch does expect private markets to develop the capacity to do so over time.<sup>8</sup> Meanwhile, the highest risk business is likely to shift to the FHA due to an assumed Gfee pricing increase that will be required to cover the 4% capital requirement.<sup>9</sup> Lower origination volumes combined with increased credit risk in their retained portfolios creates a volatile business model that will dampen private market investment into the Enterprises. This creates significant uncertainty as to whether or not the Enterprises will be able to fulfill their essential role in providing liquidity support to the markets, and other statutory missions. In the words of Federal Reserve Vice Chairman Quarles, “...promoting the safety, soundness, and *efficiency* of the financial system [is] one of the most important roles of the Board. Improving efficiency of the financial system is not an isolated goal. The task is to enhance efficiency while maintaining the system’s resiliency.”<sup>10</sup> Therefore, Arch recommends the FHFA adjust the Leverage Ratio to incent prudent credit risk management and a robust CRT program, thereby ensuring a balanced business model that maximizes private investment into the U.S. housing market while maintaining they Enterprises resiliency.

### 3.1. The 4% Leverage Ratio is too Conservative

In general, the 2020 Rule proposes the Enterprises maintain 2.5% of total adjusted assets, plus 1.5% of Tier 1 Capital as the Prescribed Leverage Buffer Amount (“PLBA”), for a total Leverage Ratio of 4% of adjusted assets. The FHFA has made a concerted effort to align the 2020 Rule with the framework applicable to large banks. While similar to banks in some respects, there are crucial differences that must be accounted for. Most notable is the systemic importance of the Enterprises, and thus need for a going-concern capital regime, which FHFA appropriate recognizes. More fundamentally, however, the Enterprises are more like monoline insurance

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<sup>8</sup> To prevent simply reducing credit availability and/or pushing risks to the FHA as the GSEs’ footprint shrinks, certain regulatory changes are needed to the rules governing private label securitizations (such as Reg. ABII and the risk retention rules), significant risk transfer (“SRT”) for loans held in portfolio by banks and possibly the Federal Reserve’s conduct of extraordinary monetary policy.

<sup>9</sup> In a recent analysis published by the Urban Institute, they estimate that 10-14% of originations will shift away from the GSEs, two thirds of which to private markets and one third to the FHA. See *FHFA’s Capital Rule is a Step Backward* at <https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward.pdf>

<sup>10</sup> *Liquidity Regulation and the Size of the Fed’s Balance Sheet*. Remarks by Randal K. Quarles Vice Chairman for Supervision Board of Governors of the Federal Reserve System, Stanford University Conference, May 4, 2018. <https://www.federalreserve.gov/newsevents/speech/files/quarles20180504r.pdf>

companies than diversified deposit taking institutions. Thus, the FHFA must adopt a thoughtful regulatory framework in which similar risks are treated similarly, while appropriately tailored to the distinct business model and operations of the Enterprises, keeping in mind the crucial differences between the retained risks of the Enterprises and banks. First and foremost, unlike banks, the Enterprises do not hold demand deposits or face the risk of a “run” on deposits. Moreover, they do not take significant liquidity or interest rate risk following the issuance of their mortgage backed securities. Yet, the 1.5% buffer capital is in excess of the buffer capital required of banks, and despite the absence of these other risks, the overall Leverage Ratio is almost 2x the net risk-based capital requirements (excluding the systemic and stability buffers).

The FHFA states that “the leverage ratio requirements are intended ... to safeguard against model risk and measurement error with a simple, transparent, independent measure of risk.”<sup>11</sup> Arch agrees that including a Leverage Ratio is an important feature of the framework, but calibrating it too conservatively to control for model risk and measurement error is duplicative of the adjustments and buffers already included in the framework to address these same risks. The table below highlights many of the adjustments and conservative features of the 2020 Rule that bolster the risk-based capital calculation and make it unnecessary to set the Leverage Ratio even higher to address model risk and measurement error.

Conservatism	Arch Comment
<b>CRT haircuts</b>	As commented above, the CRT haircuts are so punitive as to disincentivize the sound practice of risk transfer.
<b>Countercyclical Adjustment</b>	The countercyclical adjustment reflects a 25% home price decline below the long-term trend, which, when the housing market is heated, is more conservative than the 25% peak to trough decline assumed in the financial crisis replay assumed in the 2018 Rule. If housing is overvalued by 20% in any origination year, the rule imposes a ~35% $(1-0.75/(1.2-0.05))$ peak to through decline.
<b>No Future Gfee</b>	In any stress, future Gfees on the vast majority of loans that don’t default act as a significant source of claim paying resources. Conservatively assume: 25bps of Gfee to cover unexpected loss, 80% of borrowers don’t default under stress, and an average life of 5 years = 100bps of loss absorbency. This is an implicit embedded capital buffer that is not included in the propose rule.
<b>Buffers</b>	The stress and stability capital buffers are equivalent to 80% of the risk-based capital requirements and are based on total assets rather than risk weighted assets. The countercyclical capital buffer gives further room for discretionary additional capital.
<b>15% Risk Weight Floor</b>	Applied at the loan level, this further introduces additional conservatism relative to the 2018 Rule.

The loan-level minimum risk weight floor of 15% combined with the elimination of the number of borrowers and loan size from the risk-based grids materially increases cross subsidization within the model. Together with overly conservative risk insensitive buffers and a binding Leverage Ratio, the 2020 Rule is significantly less sensitive to risk than the 2018 Rule and results in a business model that will be less attractive to private capital providers.

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<sup>11</sup> 85 Fed. Reg. 39281 (June 30, 2020).

Cross subsidization is predicated on an evenly distributed risk profile across credit and time. The 2020 Rule, as proposed, is not likely to result in this distribution. Rather, adverse selection will result in the loss of low and moderate risk business and will force even higher prices for the risky business to achieve an adequate return. The GSEs will buy and hold the credit risk on riskier loans because engaging in CRT without receiving credit is capital inefficient, and similar to the last financial crisis, the GSEs may not have the ability to serve the market in times of stress. A concentrated high credit risk portfolio supported by inefficient capital is not an attractive proposition from a private capital perspective.

### 3.2. Reduce the Leverage Ratio

FHFA states that it believes that “mortgage market conditions as of September 30, 2019 reflect circumstances consistent with a period under which a credible leverage ratio would be binding...”<sup>12</sup> based on the following factors:

- strong house price appreciation since 2012,
- the unemployment rate at a historically low level,
- the strong credit performance of mortgage exposures as of that time,
- robust CRT market access enabling substantial risk transfer, and
- the generally strong condition of key counterparties, such as mortgage insurers.

While Arch agrees that conditions were very strong at that date and it is appropriate to have a binding leverage ratio under these conditions, putting a floor on capital of ~2x the risk-based amount is too conservative. Consistent with its comments in response to the 2018 Rule, Arch recommends FHFA adopt the bifurcated approach that requires 1.5% of trust assets and 4% of non-trust assets, which is approximately 2% of total adjusted assets on a blended basis. Differentiating the leverage ratio is appropriate because investors provide the Enterprises a stable source of funding that is match-funded with the mortgage assets that Fannie Mae and Freddie Mac purchase and hold in trust accounts. Arch acknowledges that the 1.5% buffer capital amount within the Leverage Ratio is a new component to institute limitations on dividends and bonus payments. As a practical matter, executives are likely to manage to a figure above the set buffer amount. Arch agrees with the purpose of the buffer but suggests that FHFA recalibrate it to 50bps. The 1.5% PBLA makes the buffer nearly 40 percent of the overall requirement, which is nearly twice the leverage buffer in the bank capital framework. Reducing the leverage buffer to 50bps will bring it in line with the bank capital rules and will result in a reasonable and credible Leverage Ratio. It is worth noting that the current post-CRT net credit risk (excluding buffers) is ~1.95%. A ~2.5% leverage ratio is currently more than 125% of credit risk requirements of the Enterprises.

By adopting an ultra-conservative approach to the level of the Leverage Ratio relative to the risk-based standard, the proposed rule introduces significant levels of inefficient capital into the U.S. housing finance system, the cost of which will be borne by the borrower. Arch estimates that the proposed rule, with the Leverage Ratio as the binding constraint, will require Gfees to increase by ~20bps resulting in approximately \$400 of additional annual payment for a \$250k mortgage. FHFA issued the 2020 Rule in the summer of 2020, in the midst of ongoing discussions between policymakers around further rounds of stimulus, including stimulus checks and

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<sup>12</sup> 85 Fed. Reg. 39281 (June 30, 2020).

unemployment benefits, to combat the economic consequences of the COVID-19 pandemic. The FHFA’s effort to closely align the Enterprises to banking leverage ratio standards to the Enterprises is inappropriate given the significant differences in business models; the costs are not trivial, and this burden is particularly acute today.

### 3.3. The Leverage Ratio Through Time

The 4% Leverage Ratio is markedly higher than the Leverage Ratio options proposed in the 2018 Rule, and the 1.5% PLBA is higher than the corresponding leverage buffer capital that banks are required to hold under Basel III. Current Gfees are also calibrated to an approximate 2.5% capital requirement. In the preamble to the 2020 Rule, the FHFA disclosed that the Leverage Ratio is the binding constraint as of September 30, 2019. FHFA should consider releasing additional data as to when the Leverage Ratio would have been the binding constraint, as well as quarterly thereafter once implemented, to enhance transparency to the market.

In order to understand the impact of the Leverage Ratio, using publicly available GSE loan level data, Arch estimates the GSE capital requirements through time on a calendar and origination year basis in the table below. The analysis covers single-family only and the publicly available data does not include the riskiest loans originated during the crisis (and which would not be underwritten today), resulting in lower estimates<sup>13</sup> of credit capital than had these high-risk loans been included. The table below shows risk-based requirements pre-CRT, exclusive and inclusive of buffers and market/operational risk charges (for simplicity, the buffer and risk charges are held constant at the 2019 levels of 199bps).

	3.31	Calendar Year-end					
	2019	2016	2013	2010	2007	2004	2001
Risk Based Requirements (preCRT, excl buffer)	1.7%	2.0%	2.7%	4.9%	5.0%	3.0%	4.9%
Risk Based Requirements (preCRT)	3.7%	4.0%	4.7%	6.9%	7.0%	5.0%	6.9%
Minimum Leverage Ratio	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%

	Origination Year						
	2018	2016	2013	2010	2007	2004	2001
Risk Based Requirements (preCRT, excl buffer)	2.8%	2.4%	2.1%	2.3%	7.7%	5.7%	5.1%

Excluding the risky crisis era loans, which Arch believes is an appropriate way to prospectively assess the impact of the 2020 Rule given significant post-financial crisis reforms, the Leverage Ratio is binding since 2016 (green highlighted cells) – before any credit is given to CRT. A healthy CRT program and a framework which gives appropriate credit for CRT (as articulated in Section 2) will exacerbate the propensity for the leverage ratio to be binding. A risk-insensitive binding constraint is well known to distort decision-making. Combined with increasing Gfees to cover the increased capital requirement that shrinks the footprint and the incentive to take on riskier business, the resulting business model will impede the GSEs ability to provide stability and ongoing assistance to the secondary mortgage market across the economic cycle and will likely dampen investment into the GSEs post-conservatorship. It takes considerable investment of capital and expertise to be an informed investor in mortgage

<sup>13</sup> Arch’s estimate of 173 bps single family credit risk capital pre-CRT and buffers at 3.31.2019 is lower than the 211bps (net pre-CRT SF credit risk capital) outlined in the proposed rule. Arch’s analysis is based on publicly available GSE data and Arch’s replica model of the FHFA 2020 capital rule.



credit risk. Absent consistent use of CRT, private market participants will view CRT as an “orphan” asset class which will reduce the overall amount of market expertise focused on mortgage credit risk and exacerbate pricing and capacity challenges, particularly when the coverage is needed most. Similar to the recalibration of the leverage ratio remarked upon by Vice Chairman Quarles that was necessary to return the leverage ratio to a level that is a “backstop rather than the driver of decisions at the margin,”<sup>14</sup> Arch recommends adjusting the Leverage Ratio, as outlined in Section 3.2, in order to provide the Enterprises with an incentive to manage tail risk by issuing CRT transactions through-the-cycle and will prevent unnecessarily imposing a risk-insensitive binding constraint and the associated distorted incentives.

### **3.4. Recognize CRT Capital Credit as a Source of CET1 Capital**

The FHFA should also consider allowing the CRT credit recognized in the risk-based capital calculation (as discounted by the three adjustments) to count as a source of CET1 capital that can be used to satisfy the Leverage Ratio. As discussed in Section 2.2, the effectiveness adjustments conservatively address concerns about the loss absorbing capacity of CRT capital with their corresponding haircuts. By design, CRT transactions are supported by collateral held in trust that is immediately available to the GSEs for covered losses, and strong multiline reinsurers stand behind uncollateralized amounts. By covering the substantial majority of its loan portfolio with CRT protection, an Enterprise significantly mitigates any concern about the fungibility of CRT capital across loan pools and supports recognizing the protection provided by third parties as a source of capital. Thus, Arch believes it appropriate to recognize the substantial benefit from CRT transactions as a source of CET1 capital.

## **4. Adjust the Buffers in the Risk-Based Capital Requirement**

### **4.1. Reduce the Proportion of Buffer Capital and Make it Risk-Based**

The stress and stability capital buffers are almost 80% of the total risk-based capital requirements, which presents the same risks and issues discussed in Section 3. Additionally, the buffers are based on total adjusted assets, which is insensitive to credit risk. Because of this, prudent risk management and a robust CRT program can reduce only a portion of required capital. Arch believes that the totality of buffers (stress and stability) on top of the risk-based capital requirement should be no more than ~25% of the risk-based amounts, which would be ~50bps at today’s levels. Anything in excess of these levels distorts the “risk-based” nature of the framework and, by extension, the operations of the Enterprises. In support of the buffers, FHFA makes references to “model or similar risks inherent to the calibration of granular risk weights for mortgage exposures”<sup>15</sup> and the risk of underestimating stressed losses. Yet, that risk is absorbed first and principally by the CRT investor by setting the detachment point well in excess of potential stress losses, as is done today. Thus, setting buffer capital levels high to protect against such risk is misplaced when calibrating the size and proportion of the buffers. In order to

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<sup>14</sup> *Liquidity Regulation and the Size of the Fed’s Balance Sheet*. Remarks by Randal K. Quarles Vice Chairman for Supervision Board of Governors of the Federal Reserve System, Stanford University Conference, May 4, 2018.

<https://www.federalreserve.gov/newsevents/speech/files/quarles20180504r.pdf>

<sup>15</sup> 85 Fed. Reg. 39277 (June 30, 2020).

achieve its stated goal to maintain the risk-sensitive framework in the 2018 Rule, FHFA should reduce the proportion of the buffer amount and base it on risk-weighted assets.

#### **4.2. The Countercyclical Adjustment Should Be Assessed at a State or MSA-Level**

The FHFA should also modify the countercyclical adjustment as it fails to address U.S. housing market heterogeneity, as housing prices can vary widely across geographies. So long as the Enterprises have a nationally diversified footprint, a nationally assessed buffer may suffice. However, basing the adjustment on a state or MSA-level would increase the sensitivity to regional variation, reduce procyclicality, and accommodate new entrants that may not have a nationally diversified portfolio.

Further, the countercyclical buffer should be triggered based on a set of transparent objective criteria rather than regulatory discretion. If history is any indication of the future, the housing cycle experiences long periods of favorable conditions, which result in flush capital reserves. And at the very point that companies should be holding and raising additional capital, there has been enormous shareholder and political pressure to the contrary given the long tailwinds of good market conditions. Assessment of the buffer based purely on regulatory discretion subjects it to shifting political priorities. Arch recommends that the FHFA set forth a process and objective macroeconomic criteria that guide the assessment of the countercyclical buffer.

### **5. Additional Transparency & Encouraging Virtuous Competition to Enhance Counterparty Strength**

Arch fully supports differentiating insurance and reinsurance recoverability on the basis of counterparty strength and agrees that the creditworthiness and mortgage concentration of the counterparty are the primary considerations. The haircuts, ranging from 1% to 48%, provide sufficient differentiation to distinguish between counterparty financial strength. This approach is appropriately prudent and will provide material counterparties an incentive to focus on maintaining and/or enhancing their financial strength. The framework benefits well-diversified counterparties and aligns with the approach currently used within collateral requirements for participants in CRT.

However, the mechanism for assigning ratings lacks transparency, both with respect to the methodology used to assign a counterparty rating of 1-8 and the determination of whether mortgage concentration risk is “high” or not. Regarding counterparty strength, for example, it would be helpful to know the relative importance of pricing discipline, underwriting profits, capitalization, market share, and risk management practices and how these factors inform the rating. Regarding the assessment of mortgage concentration, Arch believes there is considerable benefit to being part of a larger multi-line group with significant diversification, but it is not clear whether the Enterprises’ frameworks are applied separately for each legal entity within a group or evaluated at the group level. In addition, it is unclear how the Enterprises set their internal counterparty concentration limits and whether there is latitude for stronger counterparties to exceed such limits. Finally, it is unclear whether an insurance or reinsurance counterparty’s own risk transfer strategy impacts its rating. Recognizing that the GSEs have different methodologies, Arch suggests that the FHFA require the GSEs to publish their methodologies to assign counterparty ratings and to assess mortgage concentration, and to share individual ratings with counterparties. The goal of such transparency is to create “virtuous competition,” as counterparties manage their



operations and risk aggregations to maximize the credit enhancement the GSEs can recognize from doing business with strong counterparties. However, this only works if companies have clarity on how they can progress in counterparty ratings.

## 6. Multifamily

Arch broadly agrees with the segmentation used within the multifamily framework and believes the gross capital charges are appropriate. The base grid and risk multiplier factors reflect the key drivers of multifamily performance, are directionally correct, and the relativities are reasonable. While the overall multifamily capital levels are much higher (approximately 3.5x) compared to the 2007 origination year experience, which is the highest in historical data, the 2008 financial crisis was just one particular type of stress and given the significant idiosyncratic risk within multifamily outcomes, Arch believes the higher capital requirement to be reasonable. However, Arch believes that the FHFA should further refine the multifamily framework and recommends two changes to reduce the pro-cyclicality of the capital requirement and to correct a flaw in the CRT loss timing adjustment.

### 6.1. Counter-Cyclicality

Given the reliance of the multifamily base grids on MTMLTV and MTM debt service charge ratio (“DSCR”), the current proposal introduces significant pro-cyclicality into the framework. Increasing property values and DSCR (driven by increases in income) will drive a reduction in required capital in a strong economy, while under stress, required capital would increase at a time when capital is scarce. To ensure the GSEs’ resilience to serve the multifamily market throughout the economic cycle, Arch recommends adjusting the framework to reduce to procyclicality of the capital requirement.

As stated in the 2020 Rule, FHFA does not include an adjustment to mitigate the pro-cyclicality of the aggregate risk-based capital requirements due to the difficulty in developing a reliable long-term trend in multifamily property values.<sup>16</sup> Given this limitation, Arch recommends two potential improvements:

1. The FHFA could evaluate, with input from market participants, a point in time when the multifamily market is deemed to be fairly valued. Long-term property/income values could be assumed to increase at ~3-5% per annum (or another long-term growth rate deemed adequate), and “adjusted” MTMLTV/DSCR could be calculated similar to the single-family countercyclical adjustment. While imperfect, this approach would remove much of the pro-cyclicality within the proposed framework.
2. Alternatively, FHFA could revert to using original LTV and DSCR. While we recognize that default propensity decreases as multifamily properties build equity and income levels, required capital should not decrease when property/income values exceed long term growth rates. Reverting to original LTV and DSCR, which typically produces a more conservative capital requirement in a growing economy, is better for the long-term stability of the housing finance system than a pro-cyclical capital requirement.

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<sup>16</sup> 85 Fed. Reg. 39324 (June 30, 2020).

## 6.2. Enhance Credit for Multi-family CRT and Adjust the Loss Timing Factor

Capital credit for multifamily CRT is recognized under the same framework as single-family. Accordingly, the discussion on enhancing credit for single-family CRT also applies to credit for multifamily CRT. In addition, Arch recommends an additional adjustment specific to multifamily CRT. The 2020 Rule includes a loss timing adjustment or factor (“LTF”) that accounts for maturity differences between the CRT coverage period and the underlying mortgage exposures and is currently defined as<sup>17</sup>:

$$LTF_{\%} = \frac{CRT_{RMM}}{MME_{RMM}}$$

Where:

$CRT_{RMM}$  = The remaining months to the contractual maturity of the CRT.

$MME_{RMM}$  = The remaining months to maturity of the underlying multifamily mortgage exposures. If the underlying multifamily mortgage exposures have different maturity dates,  $MME_{RMM}$  should reflect the multifamily mortgage exposure with the longest maturity.

Using the longest maturity to derive the loss timing adjustment could lead to inappropriate outcomes. For instance, the Freddie Mac multi-family CRT issued in 2Q 2020 (MCIP 2020-R3) had a remaining loan term on the longest maturity loan of 355 months compared to a weighted average remaining loan term of all loans in the pool of 122 months. As currently defined, the LTF would be 42% for the entire reference pool based on the attributes of a single loan. With 95% of the MCIP 2020-R3 reference pool having a remaining loan term within the deal term of 150 months, the current approach is overly punitive and creates a disconnect between LTF, as currently defined, and the exposure that is not covered within the CRT deal term.

Arch, therefore, recommends the following calculation for the multifamily LTF:

$$LTF_{\%} = \frac{\sum_{i=1}^n \min\left(\frac{CRT_{RMM}}{MME_{RMM(i)}}, 1\right) * MME_{UPB(i)}}{\sum_{i=1}^n MME_{UPB(i)}}$$

Where:

$CRT_{RMM}$  = The remaining months to the contractual maturity of the CRT.

$MME_{RMM(i)}$  = The remaining months to maturity of the underlying multifamily mortgage exposure (i).

$MME_{UPB(i)}$  = Unpaid principal balance (UPB) of multifamily mortgage exposure (i).

n = Number of multifamily mortgage exposures within the CRT pool.

Using this calculation means that all loans with remaining maturities greater than the CRT coverage period are reflected in the calculation (weighted by loan UPB), rather than just the loan with longest remaining term. Arch has also been careful to construct an approach so that loans with remaining maturities shorter than the CRT

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<sup>17</sup> 85 Fed. Reg. 39395 (June 30, 2020).

coverage period do not contribute to the LTF calculation.<sup>18</sup> Thus, Arch's alternative calculation produces a more accurate, yet still conservative, loss timing factor.

## 7. Conclusion

The Re-proposed Rule on Enterprise Capital is foundational to creating a prudent going-concern capital requirement that ensures the GSEs operate in a safe and sound manner consistent with their statutory purposes. With a few important revisions, the FHFA can achieve this important objective while also encouraging substantial private capital investment into the U.S. housing finance market needed to support the GSEs and broader housing markets as they move toward exiting conservatorship. Arch remains committed to working collaboratively with the FHFA, the GSEs, industry and other stakeholders to develop a robust regulatory framework that creates a more stable and sustainable mortgage market post-conservatorship that balances the interests of consumers, taxpayers, market participants and the U.S. economy as a whole.

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<sup>18</sup> Including loans with remaining maturities shorter than the CRT coverage period for MCIP 2020-R3 would make the LTF greater than 1.