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COMMENT ON THE FHFA PROPOSED CAPITAL FRAMEWORK
Docket No. 2020-11279
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Thank you for the opportunity to comment on the Federal Housing Finance Agency's (FHFA) proposed rulemaking for a new capital framework for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporate (Freddie Mac) hereinafter referred to as "the Enterprises."

I write in a personal capacity, as one who has observed and experienced the challenges of capital requirements from a variety of perspectives: as the U.S. Department of the Treasury's Assistant Secretary for Financial Institutions in the early 2000's, where I oversaw banking and housing finance policy during a time when the private label mortgage-backed securitization market was rapidly expanding, incentivized by the exploitation of gaps and arbitrage opportunities in the risk-based capital rules applicable to banking organizations and the Enterprises; later, as a board member of the Center for Responsible Lending, where I observed how this explosion in private label securitization was funding abusive and unaffordable mortgage lending; and finally as the Chair of the Federal Deposit Insurance Corporation (FDIC) during the financial crisis, when I had to deal firsthand with the economic devastation caused by a deadly combination of irresponsible risk taking and high leverage in the financial system, enabled by weak capital regimes.

I am well aware of the tensions and controversies surrounding capital requirements. Few areas of regulation give rise to more passion, controversy, and conflicting narratives around "risk" and the quantity and quality of capital necessary to ensure that our major financial institutions can continue to operate and perform their public obligations through economic cycles, particularly during periods of economic stress. For the Enterprises, this question becomes even more urgent given the prospect of their exit from conservatorship, when they will be owned, once again, by private shareholders who will be seeking to maximize returns on their investments.

A Highly Credible Framework

I believe the FHFA has proposed a highly credible framework for the Enterprises: one that should provide assurance to taxpayers that private capital will have sufficient "skin in the game" and that they will not again be exposed to a model of privatized profits and socialized losses; one that should provide assurance to bondholders that adequate cushions of capital will protect them from defaults; and one that should provide assurance to long-term shareholders that they will have an investment providing fair returns but also safety and stability.

This is a brave proposal-one that has engendered support but also criticism and arguments that it will adversely impact housing finance access and affordability, particularly for low and moderate income (LMI) families. I understand these concerns. Indeed, during the years leading up to the crisis, one reason some regulators gave for not tightening capital rules was the argument that tighter standards would reduce access to credit for Main Street. But what we learned from the Great Financial Crisis (GFC) is that weak capital requirements lead to financial instability and crisis and that the brunt of the damage caused by that instability falls disproportionately on LMI families, and African-American families in particular. Massive foreclosures and job losses reduced their wealth which they have not recovered. Indeed, household wealth for these families is lower than it was two decades ago.[1] Multiple studies have shown that banks with strong capital cushions did a much better job of lending through the GFC than their bailout-seeking highly leveraged competitors, providing credit to households when it was needed the most. They have also shown that the impact of higher capital requirements on credit costs are marginal and are far outweighed by financial stability benefits.[2]

That is not to say the sky is the limit when it comes to capital constraints. But the rule FHFA has proposed seems to strike a good balance. While much stronger than the 2018 proposal, it would still only require roughly half as much capital as would be required under rules applicable to globally systemic banks, which protect the FDIC from losses. This is perhaps justified by the Enterprises' relatively simpler business model, but certainly taxpayers have no less interest than the FDIC in loss absorbing capital.

Support for the Leverage Ratio

I am very pleased to see that the framework makes good use of leverage ratios to complement risk-based requirements. Risk-based capital rules are highly pro-cyclical, prone to error, and as discussed below, use proxies for credit risk that disproportionately impact LMI families. Leverage ratios mitigate these adverse features of risk weighting. Importantly, leverage ratios proved to be much more reliable during the GFC as measures of financial integrity.[3] Indeed, the banks most prone to fail during that time period were those that reported weak leverage ratios but strong capital levels based on "risk" adjustments.[4] *Former FDIC Vice-Chair Tom Hoenig has written an excellent comment letter on the FHFA's proposal, with a particularly good discussion of leverage ratios, which I support and commend to the FHFA.*

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[1] https://www.pewsocialtrends.org/2020/01/09/trends-in-income-and-wealth-inequality/screen-shot-2020-01-08-at-5-06-47-pm/

[2] https://www.fdic.gov/about/learn/board/hoenig/2016-05-12-lr.pdf

[3] See, e.g., J. Norton, "A More Prominent Role for the Leverage Ratio in the Capital Framework" Remarks before the Florida Bankers Association (Feb. 6, 2013) https://www.fdic.gov/news/speeches/spfeb0613.html

[4] https://www.bis.org/publ/bcbs180.htm

Addressing Bias

I also wish to recognize the FHFA's attempts to address bias in risk weights. Current risk weightings for residential mortgages unjustifiably discriminate against borrowers viewed as "subprime" because of their low credit scores and lesser wealth. In fact, as Karen Petrou[5] and others have pointed out, studies have found that during the GFC, subprime borrowers actually performed better on their mortgages than those prime borrowers who borrowed to buy vacation homes, investment properties, or simply to speculate on residential real estate. There was little to lose by these borrowers walking away from their debt obligations, while subprime borrowers were desperate to hold on to their homes. The consequences of default were also more severe for subprime borrowers given their higher reliance on access to credit as a lifeline.

The use of credit scores and loan-to-value (LTV) ratios as primary risk indicators disproportionately impact these lower income families, while relying on imprecise proxies for credit worthiness. Much lip service has been given to reporting to credit bureaus rent, utility bill payments, and other indicia of financial responsibility which would benefit LMI families, but far too little has been done. It's been estimated that less than 1% of credit files contain rental entries.[6] Particularly given the stagnant wage growth which characterized much of the "recovery" period after the GFC- and now the pandemic-- working LMI families struggle to save enough for significant down payments. Yet, intuitively, who is the greater credit risk? For my part, I would rather lend to a lower income family with a strong multi-year record of regular rent and utility payments than a wealthy real estate speculator. But current risk weightings provide a capital penalty for my low income family, while rewarding the gambling prime borrower with deeper pockets.

Primary reliance on credit scores and LTVs to risk weight capital requirements make it significantly more profitable to guarantee wealthy borrowers. FHFA's proposed framework would mitigate this capital advantage by placing a minimum 15% risk weight on all residential mortgage loans. The minimum risk weight also addresses the inherent uncertainty in estimating losses based on imperfect risk factors like credit scores and LTVs. Counter-intuitively, the argument has been made that by reducing the capital advantage given to guaranteeing wealthier "low risk" borrowers, the proposal will increase guarantee fees for "high risk" borrows as it will reduce profits available from the former to cross subsidize the latter. Cross subsidization is certainly a reality now, but it is largely at the Enterprises' discretion, and the FHFA should evaluate how incentives might change post-conservatorship. Should the FHFA accept this argument and adjust or eliminate the 15% floor, it should also consider more robust reporting requirements to monitor and evaluate the extent to which profits on "low-risk" borrowers subsidize LMI households.

The FHFA's proposed framework mitigates bias in two other important ways. It removes from secondary risk factors multipliers which treat as "high risk" loans of less than $100,000 and loans with

[5] See, e.g., K Petrou, "The Fed Must Address the Penalties for 'Banking While Black'" Financial Times, June 24, 2020

[6] B. O'shea, How to Report y our Rent to Credit Bureaus, Nerdwallet, Aug. 18, 2020

a single borrower, penalizing single-earner households. Both have been roundly and rightfully criticized for disadvantaging LMI families.

Going forward, I hope the FHFA and Enterprises can do more work to eliminate discriminatory bias in the risk weighting of residential mortgages. I am hopeful that advances in technology and data analytics will eventually provide the means to reduce reliance on blunt instruments such as LTVs and credit scores with more nuanced and accurate assessments of risk—those based on a more holistic view of a borrower's record of financial management and actual cash flows. I realize that past efforts to "open the credit box" have not always turned out well and that such changes need to be undertaken carefully. Yet, past missteps should not divert FHFA and the Enterprises from continuing to try to find more accurate and inclusive indicia of risk.

Conclusion

To protect lower wealth borrowers and lead to a more inclusive system of housing finance, the distribution of capital is at least important as the quantum. Adequate capitalization is necessary for financial stability. We know that financial instability caused by excessive leverage in the financial system most severely impacts low wealth families and families of color. I do not discount concerns that higher capital requirements will place pressure on guarantee fees. Yet the degree of those g-fee increases will be impacted by a variety of factors including the exposures to which the new capital rules apply going forward, the time period over which the capital needs to be raised, and the desired level of returns on equity once the Enterprises exit from conservatorship. It should be noted that giving the Enterprises more latitude to diversify revenue sources could make them more stable institutions, while easing pressure on g-fees which lenders all too quickly pass on to borrowers. This too would need to be carefully done to avoid "charter creep" but is worth exploring.

Having advocated for stronger capital rules throughout my career, I appreciate the challenges of the task before you. I congratulate you on a thoughtful, well-crafted proposed capital framework. Again, these are my personal views and do not represent the views of any other organization with which I am or have been affiliated. Thank you for the opportunity to present them.

Sincerely,

Sheila C Bair

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