American Bankers Association
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The Honorable Mark Calabria
Director
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20219

Dear Director Calabria,

Re: Notice of Proposed Rulemaking and Request for Comments – RIN 2590-AA5

The American Bankers Association ("ABA")[1] appreciates this opportunity to comment on the Federal Housing Finance Agency's ("FHFA" or "the Agency") re-proposal of capital standards for Fannie Mae and Freddie Mac ("the Enterprises" or "GSEs").

The re-proposal revises and expands upon the version proposed in 2018, upon which ABA submitted significant comments. While we believe the re-proposal addresses some concerns raised by ABA and others with regard to the previous proposal, the re-proposal raises concerns of its own, particularly with regard to the implications for the primary market and our members' continued ability to sell loans to the GSEs in the revised GSE marketplace implied by the re-proposal. Where the previous proposal was speculative in nature, intended only to become applicable once Congress had acted to remove the GSEs from conservatorship, the re-proposal is more directive in nature, and suggests a foundation upon which a reformed GSE market can be constructed, potentially through regulatory action. As such, the re-proposal may be viewed as more consequential. With that in mind, we think it appropriate to focus our comments on the implications for the primary market, and more specifically for our members' ability to sell loans to the GSEs in a reformed system governed by the proposed capital rules. Therefore, while we offer a short critique of the re-proposal's capital framework and offer suggestions intended to help improve it, the bulk of our comments will focus on the future direction and environment implied by the re-proposal and the impact on our members' who originate and sell mortgages to the GSEs. Key among our recommendations is that FHFA needs to provide more clarity about the post-conservatorship role that it expects the GSEs to play vis a vis other market players, and to provide more data to explain the choices made in setting particular capital standards.

Summary of the Re-proposal

The re-proposal of Risk Capital rues must be understood as being based on an approach that

[1] The American Bankers Association is the voice of the nation's $20.3 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $15.8 trillion in deposits and extend nearly $11 trillion in loans.

is fundamentally different – using a very different methodology to calculate risk weights - than do the basic risk-based capital models used by US bank regulators and other Basel (BCBS) regimes.

The proposed rules are a complex mixture of both product-specific and very large general layers of capital that the Enterprises must hold against their total assets (as defined). To a great extent, the proposed rules may increase product-specific price differentials for g-fees on specific mortgage products to be included in securitized pools. Banks and all others who choose to sell product to the Enterprises will be forced to make some choices about which products to distribute via the Enterprises, which to seek FHA/VA execution, and which to sell through third-party channels or retain in-house. The proposed rules may also create incentives to change the strategic behavior of the Enterprises, including decisions to grow, shrink, or change their product and sector mixes going forward.

The Enterprises have been operating under government conservatorship for a dozen years, and prior to that were obviously underpricing credit risk. The Enterprises, while not historically viewed as similar to insurance companies, have decreased their portfolio business and can perhaps conceptually be viewed, in comparison to banks, as large insurance companies selling various lines of guaranties and, increasingly, utilizing credit risk-transfer and risk sharing strategies similarly to large insurers, although there is no global insurer that comes near the size of either of the Enterprises. The re-proposal makes several improvements over the 2018 proposal to address some of the pro-cyclicality that would have complicated the needed capital raise necessary to release the Enterprises from conservatorship.

The re-proposal also revises the previous proposal's approach to Credit Risk Transfers (CRT), treating CRT as an inferior or uneconomic substitute for unencumbered equity. Nevertheless, we continue to believe that there is an important role for CRT transactions in the capital structure of the Enterprises, and the re-proposal may go further than necessary in restricting the use of these innovative tools.

The model proposed by FHFA will, by implication, require the Enterprises to raise significant amounts of new equity, perhaps in excess of $200 billion. It is not infeasible that the Enterprises, upon resolution of certain issues with the Treasury, might raise the required amounts and it is also not so unlikely for the Enterprises – over some ramp-up horizon - to earn a minimal return of their existing and incremental books of guaranty business. Potential statutory reform will also affect the ability to raise capital, the recent proposal notwithstanding.

Undoubtedly, adoption of the proposal in its present form will change absolute pricing levels, relative product pricing and even availability of products. It will also affect what portion of mortgage originations go into the secondary market with Enterprise guarantees. In the following pages we will discuss the risk-based capital models of the re-proposal, how they are different from risk-based capital and leverage regimes used by US banking regulators, the various capital buffers added by the re-proposal, and how, taken together these imply significant changes in loan

pricing, product availability and Enterprise secondary market shares that will impact the primary market.

Credit Risk Weighting in the Re-proposal

The credit risk portion of the FHFA model is based on allocations of risk (applied as a percentage of Unpaid Principal Balance or "UPB") that the Enterprises must cover beyond normal earnings flows and provisions for anticipated losses.

The credit risk amount is calculated – as reflected in the published grid - as a percentage of 4% for mortgages, where the percentage of 4% of UPB varies based upon the loans' credit score and mark-to-market loan-to-value ratio or "MTMLTV" - an estimate of the loan's current collateralization, based on the original LTV ("OLTV") and subsequently adjusted by a national house price index ("HPI"). As the HPI increases over time the MTMLTV decreases.

For example, a performing loan with a credit score greater than or equal 700 and less than 720, and an MTMLTV greater than 75 and less than or equal to 80 would require the enterprise to hold 47% of the 4% risk weight, or a 1.88% capital charge. This is less than the 4% risk weight that a typical bank would carry.

A loan that had considerable HPI growth since being put on the book of the business of the Enterprise, but now with between 30% and 60% MTMLTV, and the same credit score slot as in the previous example would have a 5% risk factor, or 5% of 4% equaling 2 basis points of required RBC. To avoid criticisms that arose around such outcomes previously, the re-proposal sets an across-the-board floor of 15 basis points of required risk capital. This implies that the Enterprise would at minimum hold $150 of RBC against a loan with a remaining UPB of $100,000. Still, this is far more generous than the approach applied to banking institutions.

There are four sets of such grids, and re-performing loans (both modified and non-modified) and non- performing loans have grids with higher risk weights than do performing loans. Additionally, the re-performing loans grid uses months of re-performance as one of the credit variables, rather than credit score.

The FHFA indicates that these grids, and similar grids for multifamily, are based on historical performance data from the Enterprises. Still, there is an element of arbitrariness:

1) In the decision on where FHFA has centered the grids (what percentage of 4% is actually comparable to bank experience), and

2) The MTMLTV feature, of which nothing comparable exists in bank capital, is seemingly like an actuarial weight, where the potential of a claim trails off to insignificance

FHFA should provide greater clarity as to their thinking, preferably backed by published data to show how they have arrived at the percentages they apply, and how the percentages can be justified, compared to applicable bank percentages.

In addition to the grids, there are product-specific adjustors (called "Risk-multipliers"). Using the previous example, if the performing loan is a purchase money loan, the multiplier is 1, so the risk weight is the 1.88% capital charge – but if the loan were a cash-out refi the multiplier would be 1.4 - 40% higher - so the risk weight would be 1.88% times 1.4, or 2.63%. If g-fees follow risk weights, will a cash out refi have a 40% higher g-fee? The grid and multiplier system creates strong incentives for pricing changes.

Another example would be the Risk-multiplier for 15 and 20 year FRMs, which would be 30% and 60% of the 30 year FRM case. Using the 700-720 credit score, 75-80 MTMLTV example, the risk weight would be adjusted down to 30% of 1.88% on a performing loan, or a .564% capital charge. Would g-fees follow such incentives? The underlying market rates on 15 year fixed rate mortgages and 20 year fixed rate mortgages is largely driven by the shorter prepayment (and perhaps yield curve effects), but now we are introducing economic incentives that powerfully favor lower risk pricing on mortgages other than 30 year fixed rate mortgages.

There are several more Risk-multipliers other than those mentioned here (e.g., for DTI, "cohort-burnout", loan age – that are in addition to MTMLTV). There might be good reasons that support the way FHFA has chosen to apply risk weights and product adjustors (Risk-multipliers) for single family and multifamily credit risk as well, but the motivating reasons are not transparent. Does the FHFA want the Enterprises to shift their business (product mixes) in certain directions and is using credit risk charges to achieve that? Perhaps the FHFA wants to shift some single family business to FHA/VA, since that appears to be one likely incentive created by the rules. In any event, FHFA should provide a clear and detailed blueprint or roadmap for the resulting secondary market that they envision – for the GSEs, for competitors, for the private market, and for other governmental agencies like FHA and VA. It seems clear that there is an intent to use the capital structure to drive market changes, and FHFA should be clear and transparent as to what outcomes they are seeking to achieve.

Capital Buffers

In addition to the netted credit, market and operational risk, (which totals about 2.29% of average total assets ("ATA") of the combined Enterprises[2]) the proposed rules include three significant Prescribed Buffers that did not exist in the 2018 proposal and collectively make up what is referred to as the Prescribed Capital Conservation Buffer Amount:

- **Stress Capital Buffer** – this amount is proposed as 75 basis points (0.75%) of adjusted total assets, a relatively large add-on. It is described as a going concern buffer, or buffer that is meant to be depleted as part of net capital exhaustion in a severely adverse scenario, and replaces the "Going-Concern" buffer from the 2018 proposal. It is 75 bps for both Fannie and Freddie, though they might have differing risk profiles. The FHFA

[2] Note that all figures are presented as a point in time percentage of ATA or in dollars as of 9/20/2019 as per the Re-proposal document.

invites comments as to the appropriateness of the buffer [3] and also seeks comment as to whether it should be periodically resized similar to the Fed's exercises for large banking organizations. We would note only that, as the proposal states that FHFA is suggesting that other market participants (presumably FHA's MMI fund) should not necessarily have a similar buffer. The MMI fund uses an actuarial model for minimum capital. More discussion from FHFA as to why the stress buffer is superior to the actuarial model - or why the GSEs differ in ways that make use of a buffer more appropriate would be welcome and encouraged. [4]

- **Stability Capital Buffer** – this Stability Capital Buffer is "tailored to liquidity, efficiency, competitiveness and resiliency of national housing finance markets" and is not the same for each enterprise. It is based on each Enterprise's share of mortgage debt outstanding so Fannie Mae's stability Capital Buffer in the proposal is 1.05% of their ATA, while Freddie Mac's is 0.64%. In conjunction with factors such as "Risk-multipliers" on certain loan types – the RBC regime has distributional incentives as well. Clearly, there are certain market shares for each Enterprise and certain loan types that will be charged more/less than others, and the resulting picture of the mortgage market will shift accordingly. It is not enough to couch these potential choices in terms of "efficiency, competitiveness and resiliency". If the FHFA has a view about who should have which shares of the primary and secondary mortgage market, it should be transparent about that view or objective. If, in fact, this is just a coincidence of factors, the FHFA should be mindful of that, and do scenario testing – published testing - about the interactions of the Stability Capital Buffer and per-product Risk-multipliers.

- **Countercyclical Capital Buffer Amount** - this amount is initially set at zero (0) in the Re-proposal and would only be implemented "when excess credit growth is judged to be associated with a build-up of system-wide risk."[5] It is worth noting that the single family credit risk model FHFA is proposing is heavily driven by MTMLTV, and within the MTMLTV framework, FHFA is already proposing a countercyclical adjustment. Whether these adjustment's overlap or are duplicative should be addressed.

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[3] Fed. Hous. Fin. Agency & Dept. of Hous. & Urban Dev., Enterprise Regulatory Capital Framework 84 (last updated June 24, 2020), https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/Ent-Reg-Capital-Frmwk-NPR-Updated-Vsn.pdf [hereinafter *May 2020 Re-proposal*].

[4] For example, the FHA insures only against credit losses, paid after a claims process. The Enterprises also make a timely payment guarantee and clearly would require some type of additional capital buffer: "stress", "stability" or otherwise to absorb unexpected business losses from operational and catastrophic risks.

[5] *Id*. at 16.

Within the credit risk capital calculations, there is a proposed adjustment limit to the MTMLTV formula in effect when a broad measure of home prices (HPI) is growing more than 5% faster (or slower) than the rate of inflation.[6] The mechanism essentially "collars" the change in HPI to a max of 5% and a minimum of -5%. Two recent periods that would have been capped or collared would be roughly the periods 2003 to 2008, and 2011 to 2017, respectively. The FHFA invites comments about the mechanism, generally if 5% is too high, etc. It is important to note that this Adjuster does not collar the change in MTMLTV to 5% +/- inflation, but only to the extent that home prices (HPI) move 5% above the trend in CPI. Even with the collar, there is quite a bias in deflating MTMLTV over time, meaning in lowering the RBC of the Enterprises. This proposed "counter-cyclical" mechanism within the credit risk capital calculations is already unwieldy and would dampen just some more extreme cases. The need for both a "countercyclical" adjustment to the MTMLTV as well as a separate Countercyclical Capital Buffer calls into question the use of such a mixed approach. Perhaps the entire MTMLTV should be reconsidered or dropped.

- **Prescribed Leverage Buffer Amount (PLBA)** – since it is very formulaic, the Re-Proposal's (fall-back) Leverage Capital Requirements are not conceptually difficult to understand, the Tier 1 requirement is 2.5% of ATA. There is, in addition a Prescribed Leverage Buffer Amount of 1.5% of ATA, for a total fall-back minimum of 4%. Falling below this minimum prevents the Enterprise from making capital distributions (dividends and repurchases) that would otherwise be under management's discretion.

This is an important tool which will be pivotal if FHFA proceeds with plans to release the Enterprises from conservatorship, as this buffer will constrain the GSEs from making capital distributions until they have met these thresholds. While we are supportive of such controls, additional constraints will likely also be needed to ensure the GSEs do not return to excessive risk taking or other ill-advised behaviors of the past – and that private market entities, including banks, are not put in a position of competing on an uneven playing field with the GSEs if they are released from conservatorship absent having attained the full capital position required under the proposed rules. For purposes of comparison with the sizing of FHFA's back-up Leverage Capital minimum, the 2020 Dodd Frank Act Stress Test (DFAST) Test Results for banks were recently published in June 2020. Of 32 large banks (most of whom are smaller than either of the Enterprises) as a group the Tier 1 capital ratio (*not using risk weights, e.g. on a comparable basis to the Tier 1 limit in FHFA*) ended at 7.4% of assets after the severely adverse scenario. Only 2 of the 32 subject banks had an ending Tier 1 ratio less than 5% and in neither case did they approach 4%[7]. It is difficult to suggest that FHFA is using a framework or capital regime similar to that for large banks in almost any respect. That may be appropriate given the

[6] *Id.* at 118 (document starts discussion).

[7] *See* Bd. of Governors of the Fed. Reserve Sys., Dodd-Frank Act Stress Test 2020: Supervisory Stress Test Results 25 tbl. 4.A., 26 tbls. 4.B. & 4.C. (June 2020), https://www.federalreserve.gov/publications/files/2020-dfast-results-20200625.pdf. Please note that the DFAST test is an actuarial test that is not strictly comparable to FHFA or other bank RBC models, but the orders of magnitude after applying stress are telling.

differences between the Enterprises and banks, but the FHFA's usage of Basel like terminology clouds this understanding.

Operational Risk Capital Buffers and Adjustments to affect system-wide risk taking

FHFA has invited comments on all aspects of the proposed buffers. We feel that FHFA should more explicitly and fully include a discussion of these buffers or other factors addressing operational risks posed to the Enterprises, and should give less consideration to capital adjustments intended to "steer" the market.

Further, it is difficult to have an abstract discussion about various Stability and Stress Capital buffers when the Federal Reserve is currently holding $2 trillion of Agency MBS to support financial markets. The government is acting, indirectly, to support the prices of liabilities of the Enterprises in a way that is probably far more pronounced than would be small adjustments in some future capital buffers. Changes by FHFA might be of the magnitude of $5 or $20 billion on capital of, say, $230 billion. Some of these adjustments might be even smaller.

Even mechanisms such as the caps on changes in MTMLTV would be gradual. It is hard to say that they would meaningfully effect system-wide risk-taking in ordinary business cycles. Likely, they will simply impact how secondary market guarantees are priced across products, with resulting effects on primary market credit delivery and competition. We question if such efforts would truly be effective in carrying out effective economic policy. In a worst case scenario they may actually introduce volatility into the financial system and impact borrowers' ability to meet GSE requirements.

Similarly, capital adjustments intended to offset operational risks impacting the Enterprises can also be disruptive to the mortgage markets if not well considered and implemented with appropriate notice to the market. The recent surprise announcement by the GSEs of a 50 basis point fee on most refinance mortgages is an example of such an adjustment, one which has caused widespread concern in the industry and from other policy makers that a sudden and not well explained change in GSE policy will impose significant new costs on lenders and borrowers at a time when borrowers and other overall economy are quite vulnerable. The chaos this caused across the market unnecessarily damaged confidence in FHFA's long-term successful management of the agencies.

At the very least, any capital adjustments whether taken to "tweak" market behavior, or to adjust for operational risks, should be well considered, and implemented in a manner and timeline that allows the industry and borrowers to prepare and adjust so as not to unnecessarily disrupt markets or even loans in process.

Clearly the operational risks that the Enterprises face should not be taken lightly since they make a timely payment guaranty of principal and interest to MBS investors on several trillion dollars of the nation's mortgage debt. Things that interrupt this cashflow, such as payment moratoriums, catastrophic weather, fire or earthquake hazards are something that should

thoughtfully be addressed within either the capital structure or funding resources of the Enterprises, not via short-term fees and fixes.

Credit Risk Transfers

The 2018 proposal gave considerable attention to CRT products. As we noted in our 2018 comment letter, "While the general notion of credit risk transfer is appealing, the mechanics of the process, and the accounting for it, do not seem very well locked down."

With roughly two years more experience with CRT, the FHFA's views seem to have changed or the demonstrated loss absorbing/transferring ability of the various CRT programs has not been shown to be as effective as believed. We, along with others, noted in 2018 that prepayment speeds were so high in the period of CRT creation leading up to the 2018 proposal that it was difficult to draw strong conclusions. A comparison of CRT treatment by the 2018 and 2020 proposals shows a significant shift in views by FHFA:

2018 proposal		2020 proposal
FN CRT impact	- 56 bps of ATA	- 30 bps of ATA
FR CRT impact	- 85 bps of ATA	- 46 bps of ATA

Clearly, these changes indicate that the FHFA considers the CRT programs less effective than before, perhaps due to further analysis or experiential data. The Agency evaluated a variety of factors in the new treatment, including, perhaps, better inclusion of the credit risk the Enterprises retain even in the topmost tranches of CRT securitizations. Concerns exist that that the Enterprises may become over-reliant on CRT, creating an incentive to hold too little unencumbered equity capital to absorb potential losses elsewhere. Mention was made of the growth of CRT securities outstanding, which now equal in size roughly 10% of the Enterprises outstanding non-MBS bond (Agency Bond) borrowings. The CRT securities are not like plain-vanilla Agency Bonds, they are highly complex, higher-risk securities (not registered in an SEC issuance) that are pledged in some cases as collateral to other participants in the financial system. The CRT programs were intended to transfer risk from the Enterprises to a broader, diversified capital pool of investor capital, but in practice may be transferring risk to a concentrated group of investors who might re-leverage their holdings of CRT instruments.

These are legitimate considerations. Nevertheless, we feel that the current proposals' treatment of CRT may be too severe. The current proposal reduces the effective capital reduction of CRT by nearly 50 percent. This seems too much of a swing against programs that have shown real innovation in the secondary mortgage market. We strongly encourage FHFA to provide more data and analysis about both the existing CRT and possible future CRT transactions before moving forward with a capital plan that reduces the value of CRT so drastically.

Conclusion

The mortgage markets have benefited from the stability that conservatorship provided over the last dozen years. That stability has come at a high cost, including the roughly $190 billion in taxpayer funds needed to prevent insolvency of the Enterprises, and the on-going risk to taxpayers in backing them while they continue to function with very little capital. FHFA's efforts to begin the process of ending conservatorship is most welcome and overdue, and the current capital standards re-proposal is an important element of that process. Ensuring on-going stability is an equally important part of that process as well. To ensure that stability long term, it is essential that FHFA ground the capital standards in well-delineated and well-understood data and rationales for the policies adopted. It is also essential that FHFA provide a clear picture of the role that it anticipates the Enterprises playing going forward. The current proposal strongly implies a changed role for the GSEs in some segments of the market – perhaps a lesser role in first-time home loan purchases and in refinance loans. Only when there is a clearer understanding of the segment of the market that the GSEs are expected to serve will it be possible to understand whether the proposed capital standards are the right ones for the mission. We strongly urge the FHFA to provide more data about how key capital standards were arrived at, as well as a clear picture of the role FHFA expects the Enterprises to play going forward. We believe that such delineation, backed by data and analysis supporting the proposed standards, will enhance the proposal and will help to move the process forward in a meaningful way.

ABA greatly appreciates the work FHFA has put into the re-proposal and the effort to begin the process of ending conservatorship, and we particularly appreciate this opportunity to comment. We hope that our comments are helpful to the process and we stand ready to discuss any of these comments in more detail. Thank you.

Sincerely

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