August 31, 2020

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

**Attention: Comments/RIN 2590-AA95 – Proposed Rule on Enterprise Capital Requirements**

Dear Mr. Pollard:

On behalf of the National Taxpayers Union (NTU), I write to submit our views regarding the notice of proposed rulemaking ("proposed rule") amending capital requirements for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, "the Enterprises"). NTU applauds FHFA for proposing a capital rule that moves the GSEs' capital framework closer to the type of capital rules imposed on large U.S. banks and will insulate taxpayers from future bailouts like those experienced in 2008. In these comments we wish to elaborate on specific aspects of the capital rule, as well as opportunities for additional improvements.

**<u>Introduction</u>**

Founded in 1969, NTU is the nation's oldest taxpayer advocacy organization. As a nonpartisan nonprofit organization, NTU has helped to shape state and federal fiscal and regulatory policy for over fifty years. Pertinent to this conversation, NTU has been a leading voice in the area of housing finance reform by offering perspectives from a key constituency that is often forgotten in these conversations: the taxpayer. For many decades, NTU has been advocating for a better housing finance system that not only protects taxpayers, but also promotes competitive secondary markets and broad mortgage access for creditworthy borrowers. We strongly believe that the government has a role in this regard, but the status quo is not a tenable long-term solution that best serves taxpayers or homeowners or the stability of the financial sector as a whole.

NTU has been a frequent contributor to proposed rules and regulations offered by FHFA.Specifically, over the last several years we have advocated to FHFA on numerous issues, such as the sound implementation of alternative credit scoring models, suspending misguided pilot programs, maximizing the use of credit risk transfers, addressing mission creep, and so much more.

**<u>NTU's Stake in Housing Finance</u>**

In the years preceding the 2008 financial crisis, NTU was sounding the alarm bells that certain government policies put the economy and taxpayers at risk. Some two decades ago, NTU testified before the House Banking Committee highlighting the dangers the Government-Sponsored Enterprises (GSEs) pose to the nation's economy. In one hearing, NTU testified in favor of legislation that would have added modest curbs on the risks these GSEs would be permitted to take. We specifically warned Congress then that many of the conditions that triggered the Savings & Loan crisis were developing around the GSEs, which could threaten the national housing system and require unprecedented action to restore balance to the market.

As we all know too well, Congress failed to heed these warnings. From deceptive banking practices, ever-increasing “affordable housing” mandates, and regulators asleep at the switch, a perfect storm of toxic system risk was created and led to the direct meltdown of Fannie and Freddie. Their collapse directly helped to precipitate the second worst financial crisis in our history, causing more than $190 billion of taxpayer bailouts and forcing them into a government-run conservatorship.

We also can all recall that what was supposed to be a temporary patch to the financial crisis has metastasized into 11 years of inaction toward a long-term solution, abusive expansion of the GSEs, and a constant threat of another massive taxpayer-funded bailout. Since being placed into conservatorship, Fannie Mae and Freddie Mac have become more entrenched than ever. With taxpayers backing close to half of the entire $12 trillion US mortgage system, totaling $6.5 trillion, the prospect of another significant bailout of Fannie and Freddie remains high. Even during the COVID-19 crisis, in which Fannie and Freddie have necessarily taken important steps to provide some stability in the mortgage market, it is still important to at least keep an eye on long-term systemic health.

This flawed system forces taxpayers to shoulder a growing burden of risk while the government’s outsized role distorts the housing market.

**The proposed rule**

The purpose of the proposed rule is intended to provide the Enterprises, once they leave conservatorship, to have a sufficient capital buffer that enables them to continue operating after a stress event similar in size to the 2008 financial crisis. FHFA should be commended for putting forth a forward looking proposal that ensures stability and certainty to the GSEs that minimizes the likelihood of a future taxpayer-funded bailout.

Under the leadership of Director Calabria, FHFA has rightly begun to implement administrative reforms that require Fannie and Freddie to operate more like private, systemically important financial institutions. The proposed rule builds off the strong foundation set forth in FHFA’s 2018 capital rule, which was perhaps the most significant development in the housing finance space since the passage of the Housing and Economic Recovery Act of 2008. In November 2019, the FHFA announced that it would be re-proposing the entire 2018 capital rule; the re-proposed rule, modifying the 2018 rule, was published in late June 2020 after a delay.

Both the 2018 and 2020 proposed capital rules would require the Enterprises, once exiting conservatorship, to hold the higher of either a minimum leverage ratio or a risk-based capital requirement. The minimum leverage ratio would require the Enterprises to hold either capital equal to 2.5 percent of total assets or capital equal to 1.5 percent of trust assets and 4 percent of non-trust assets. The risk-based capital requirement, which follows the approach of large banks, mandates that the Enterprises hold capital equal to 8 percent of risk-weighted assets (RWAs). Importantly, the minimum leverage requirement appears to be the more burdensome and, as a result, more likely to be a binding requirement that the GSEs hold 4 percent in adjusted total assets. As of September 2019, the GSEs held a combined $6.1 trillion in assets. Using this as a rough guide, the GSEs would have to hold – at minimum – a combined $244 billion in capital.

Employing this metric, it would be more than ten times the current holdings of Fannie Mae and Freddie Mac, which are estimated to be about $23.5 billion. While $244 billion is not entirely sound, it's a step in the right direction. On a positive note, that leverage ratio has dropped from 1,000 to 1, to 250 to 1. Of course, banks and GSEs differ in structure and operations; however, it is worth noting that even the latter figure remains 20 times higher than the average bank leverage rate.

The 2020 capital rule does, in any case, make substantial improvements over the 2018 rule. The proposed rule also includes a variety of additional capital buffers common to the banking world that would be applied to the GSEs. The minimum leverage ratio assessment contains a new requirement that 2.5 percent of adjusted total assets be Tier 1 capital, the safest and most "perfect" form of bank capital. The risk-based capital requirement, in addition to requiring 8 percent in risk-weighted assets, applies to a number of other capital buffers, including a stress capital buffer, a stability capital buffer, and a countercyclical capital buffer. These buffers would increase the risk-based capital assessment by about $100 billion from the 2018 capital rule proposal.

It should not be lost in this debate the impact it would have on Fannie and Freddie's borrowing costs. Under this rule, the cost of debt would surely increase, thereby making it less likely the GSEs would be able to borrow at close to the low cost of the U.S. Treasury, which was a strong contributing factor to the rise of the GSEs precarious financial situation during the housing bubble. This important consequence would level the playing field between the GSEs, and other private secondary mortgage securitizers.

The bottom line: the 2020 capital rule is a strong improvement over the 2018 rule, and for that, the entirety of FHFA should be commended. Nonetheless, NTU believes that this solid foundation can and should be the basis of additional progress, requiring some augmentations and reorientations to ensure success.

## **Suggested Improvements**

### *Capital level*

Perhaps the most important portion of the capital rule is determining the precise level of capital the GSEs will be required to hold, and with significant ramifications. Set the requirements too low, and the GSEs would not be adequately capitalized in a crisis; on the other hand, if set too high, the cost of capital and mortgage rates will significantly increase. Noting this important balance, NTU does have some reservations that the amount of capital required will be too low. While it is true that an 8 percent capital ratio is in line with the largest U.S. banks, they also have additional capital buffers which push that ratio higher, often above 10 percent. If the true goal is putting Fannie and Freddie in line with other large financial institutions, and there is no question that Fannie and Freddie qualify as Systemically Important Financial Institutions (SIFIs), both under the statutory and FSOC definitions and in any objective assessment of their financial importance, it may be wise to increase their amount of capital holdings.

A $240 billion capital buffer in front of taxpayer losses would of course be reassuring, but would it be enough in a crisis more severe than 2008? Considering the GSEs underwrite $1 trillion more in credit risk than 2008, is using the losses stemming from the 2008 financial crisis the sole, ideal metric?

In the case of Fannie and Freddie, given their immense size and importance to the U.S. economy, it is vital for FHFA to come to this conversation by taking a more risk-averse approach. Perhaps more capital is appropriate, but just as important is the type of capital the GSEs hold; to that end FHFA should increase the tier 1 capital requirement to ensure the GSEs are holding better quality capital.

Mandating the GSEs to hold either more capital, or perhaps better quality capital, will of course result in trade offs. The most noticeable trade off of holding significant capital is its impact on mortgage rates, which is the interest rate consumers pay when they borrow from lenders. While FHFA has yet to provide any analysis of how the rule as proposed will put upward pressure on mortgage rates, it remains to be seen how it will impact consumers. The Urban Institute estimates it will increase rates by 35 basis points, but other than that estimate, there is no data available. However, if required to hold more than the proposed rate, it will ultimately increase the cost of capital which would in turn raise mortgage rates higher than what the Urban Institute estimates, but the exact range of increase remains unclear. This uncertainty calls for quick and concise study to determine how, and at what level, additional capital requirements shift from becoming beneficial to detrimental, on net.

*Credit Risk Transfer*

Perhaps the most important long-term revision regarding the rule is related to preserving the market-based infrastructure that will be necessary to support some kind of GSE transition out of conservatorship. Such a transition will depend upon institutions outside of Fannie and Freddie that do not rely on taxpayer support. FHFA proposes to substantially reduce the capital relief the GSEs receive for transferring credit risk to private investors through the credit risk transfer (CRT) market. This is a disappointing direction given the enormous success that has already occurred in offloading mortgage risk from the taxpayer's balance sheet onto private market investors. We strongly recommend FHFA reevaluate the proposal as written to better incorporate CRT and make it attractive to investors.

FHFA recognizes the need to protect its guarantees by imposing a minimum risk-weight of 10 percent for any retained CRT exposures. The proposed rule should promote, and not disincentivize private capital—including transferring first-loss credit risk through the use of loan level credit enhancement, such as private mortgage and through transferring other layers of credit risk through responsible CRT. However, NTU is concerned that the 10 percent risk weight would be too high and would make CRT a less attractive option for investors. Worse yet, that flat 10 percent risk weight is applied to all CRT exposure without taking into account the individual level of risk.

With respect to the CRT transaction section of the proposed rule, NTU agrees with the general framework put forth by FHFA. However, there are a few aspects that need to be reconsidered in order for it to result in the most economical and efficient diffusion of capital. To that end, we urge FHFA to 1) Adjust the risk weight for senior retained trances; 2) Adjust counterparty risk levels; and 3) Adjust the overall risk weight metric.

Additionally, NTU believes it paramount that FHFA make adjustments to avoid subjectivity in the counterparty rating system adopted by the GSEs when determining risk weighting. To this end, FHFA should explore ways to increase transparency in capital and operational standards as requirements that other stakeholders must follow. Perhaps using PMIERs as an example to increase transparency and level the playing field for CRT, FHFA should consider less burdensome changes, such as additional progress reports, modelling, and other useful data.

As FHFA is keenly aware, despite Congressional inaction to enact comprehensive housing finance reform, FHFA has taken some action to mitigate the risk that Fannie and Freddie pose to taxpayers while in conservatorship. Using authority granted to FHFA by Congress, in July 2013, the GSEs initiated new credit risk transfer (CRT) programs to share a portion of the credit risk linked to their guaranteed single-family mortgages with the private sector. Since the start of the CRT programs through the end of June 2018, the GSEs have transferred a portion of credit risk on approximately $2.8 trillion of unpaid principal balance, thereby decreasing taxpayer exposure.

The bulk of these risk transfers, which are called Structured Agency Credit Risk (STACR) at Freddie Mac and Connecticut Avenue Securities (CAS) at Fannie Mae, are purchased by an array of investors from across the globe. These arrangements buy securities backed by the agencies' loans that are subject to write-downs if homebuyers default. The credit risk therefore is being dispersed broadly throughout the entire global financial system.

Reinsurance and other "loss-sharing agreements" are also innovative and effective tools to limit GSE losses. If and when the GSEs leave conservatorship, they would have to hold large amounts of capital as a private entity so these risk-sharing agreements would considerably lower the amount of capital the two firms have to hold.

While CRT can be an important tool for risk mitigation, it is also important to consider other elements of housing finance reform. Even as the GSEs offload the mortgages that carry some of the most risk of default (Loan-to-Value ratios above 60 percent), they are also the most expensive for the GSEs to insure. Since private investors must be compensated at market interest rates for assuming that risk, they effectively charge more than the GSEs do to bear the risk. According to FHFA, the GSEs pay more to the private sector to assume credit risk relative to what they collect in guarantee-fees from borrowers, and the GSEs have not raised their guarantee-fees to cover the costs of those transactions.

Additionally, the Congressional Budget Office believes the GSEs' CRT transactions have so far not reduced short-term costs to the government. Balancing this against the longer-term advantages of CRT, which have far greater prospect of aiding taxpayers, will require nimble policy design. Another issue to be addressed with CRT transactions is that they could attract few investors during a financial crisis and thus can be very limited and expensive at such a time. This may simply be a planning matter requiring fiscal analysts to take a more far-sighted view.

**Conclusion**

From a legislative perspective, the prospect of comprehensive housing finance reform remains incredibly slim. However, the roadblocks in Congress have not slowed FHFA from charting ahead for the inevitable release from conservatorship and being prepared for when Congress finally acts.

Director Calabria, you and your staff are to be commended for your thoughtful and prudent approach to maintaining the financial resilience of the GSEs. The rule you have proposed, takes the GSEs much further down the road from conservancy than taxpayers might have expected. Further thought to the rule can make more progress, and avoid potential roadblocks ahead. We applaud your tireless efforts to protect taxpayers and homeowners from a future meltdown of the mortgage system. This rule, if tweaked, and eventually finalized, will truly be the most significant reform to the housing finance system in more than a decade, and for that, we thank you.

NTU stands ready to work with you, or staff, as you review comments, feedback, and suggestions to the 2020 capital rule. We once again appreciate your consideration of our views on this incredibly important issue.

Sincerely,

Thomas Aiello
Policy and Government Affairs Manager