AMERICANS for TAX REFORM

722 12th Street N.W.
Fourth Floor
Washington, D.C.
20005
T: (202)785-0266
F:(202)785-0261
www.atr.org

August 31, 2020

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
ATTN: Comments/RIN 2590–AA95
400 Seventh Street SW, Eighth Floor
Washington, DC 20219

Re: Notice of Proposed Rulemaking—Enterprise Regulatory Capital Framework

Dear Mr. Pollard,

Americans for Tax Reform is pleased to offer its comments on the Federal Housing Finance Agency's Office of Federal Housing Enterprise Oversight's Enterprise Regulatory Capital Framework. The proposed rule to revitalize Fannie Mae and Freddie Mac would help bring the Government Sponsored Enterprises closer to the end of conservatorship by strengthening capital requirements. Founded in 1985, ATR has long been a champion of free market principles and remains committed to solutions that support sound markets and minimize the burden of the taxpayer.

After more than a decade in conservatorship and amid no sign that Congress will act upon needed reforms to the GSEs in the foreseeable future, ATR believes the end of conservatorship to be the only tenable way forward for the Enterprises. Additionally, the proposed rule conforms to the statutory mandate from the Housing and Economic Recovery Act of 2008.[1] Additionally, Director Calabria has frequently indicated that FHFA is prioritizing this rule and that "the real work of reform can begin only after [FHFA] finalize the rule.[2]

Considerable progress has been made during the conservatorship to reduce the risk to taxpayers posed by the enterprises, notably through efforts to limit the GSEs investment portfolios by which the GSEs historically made bets on the direction of markets leveraging their low funding costs and taxypayer-backing, and through the development of the credit risk transfer market.

But the FHFA would not be doing its job if it allowed the Enterprises to exit conservatorship without putting additional proper and prudent safeguards in place. In fact, the Agency would all but ensure a similar catastrophe to the 2008 crisis and keep the financial burden on taxpayers if it failed to improve both the quality and quantity of capital held by the enterprises combined with other critical reforms. Thus, ATR

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[1] Rep. Nancy Pelosi, H.R. 3221, Housing and Economic Act of 2008, (P.L. 110-289), Sec. 1361(a). https://www.congress.gov/110/plaws/publ289/PLAW-110publ289.pdf

[2] Dir. Mark A. Calabria, "Prepared Remarks of Dr. Mark A. Calabria at SFA Residential Mortgage Finance Symposium. https://www.fhfa.gov/Media/PublicAffairs/Pages/Prepared-Remarks-of-Dr-Mark-A-Calabria-at-SFA-Residential-Mortgage-Finance-Symposium.aspx

applauds FHFA's efforts to bring the conservatorship to an end, and as prudent in its own right to create a stronger and more robust mortgage market.

ATR wishes to comment particularly on the provisions of the rule that outline minimum leverage ratios and determine retained exposures to credit risk transfers. We support the rule's direction to raise the leverage ratio and would be comfortable seeing it raised higher. While we are supportive of the rule, we also believe careful consideration should be given to the impact that the leverage ratio could have in discouraging credit risk transfers, which has helped serve as an important source of private capital shielding taxpayers against loses. We encourage FHFA to consider approaches that could preserve some aspects and unique benefits of the CRT market.

LEVERAGE RATIO REQUIREMENTS

ATR shares the Agency's conviction to add a minimum leverage ratio requirements, stated by the Agency "to provide a credible, non-risk-based backstop to the risk-based capital requirements to safeguard against model risk and measurement error with a simple, transparent, independent measure of risk."[3] That credible backstop provides a critical safeguard to the Enterprises' inherently undiversified portfolios and offers a solution to prudently manage mortgage credit risk.

The leverage ratio, as the proposal seeks to set it, will play a central role in maintaining sufficient capital for the GSEs. As monoline institutions, the underlying assets on the GSEs' balance sheets essentially limit diversification.[4] Other important hedges of credit risk like risk-based capital requirements will be unable to fully secure the Enterprises in the event of a downturn on their own,[5] clarifying the need for the broader leverage requirement. Essentially, the leverage ratio will help GSEs adequately hedge risk that is not accounted for in risk-based requirements.

Excessive buildup of leverage is a constant area of concern for the safety and soundness of financial institutions. While leveraging assets can promote market growth and prove profitable for institutions like the GSEs, becoming over-leveraged may produce disastrous implications, as the 2008 financial crisis made clear.[6] Thus, finding the appropriate balance of leverage is important to stimulate the market and protect shareholders and taxpayers if an institution should fail.

The tendency toward over-leveraging their assets undermines the Enterprises' mission to provide a countercyclical balance in the mortgage market.[7] By Congressional charter,

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[3] Federal Register, Vol. 85, No. 126/Tuesday, June 30, 2020, 39293. https://www.govinfo.gov/content/pkg/FR-2020-06-30/pdf/2020-11279.pdf

[4] Don Layton, "Demystifying GSE Credit Risk Transfer Part I – What Problems Are We Trying to Solve?" January 2020, page 2. https://www.jchs.harvard.edu//research-areas/working-papers/demystifying-gse-credit-risk-transfer-part-i-%E2%80%93-what-problems-are-we

[5] Norbert Michel, "Strict Bank-Like Capital Rules Needed for Fannie Mae and Freddie Mac," March 9, 2020, page 7. https://www.heritage.org/markets-and-finance/report/strict-bank-capital-rules-needed-fannie-mae-and-freddie-mac

[6] IMF Working Paper, "Mitigating the Deadly Embrace in Financial Cycles: Countercyclical Buffers and Loan-to-Value Limits," April 2016, page 5. https://www.imf.org/external/pubs/ft/wp/2016/wp1687.pdf

[7] FHFA 2019 Report to Congres, page iii. https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2019_Report-to-Congress.pdf

the Enterprises are only allowed to hold mortgages on their balance sheets, whereas traditional financial institutions like banks and credit unions are able to diversify their assets outside of mortgages alone.[8] Large, diversified financial institutions like Global Systemically Important Banks are bound by a 3% minimum leverage ratio requirement under the international Basel III Framework, [9] which the Federal Deposit Insurance Corporation effectively increased to 5%.[10] For community banks, those with total assets below $10 billion have a leverage ratio of 9% as mandated by the FDIC.[11] Taken together, the GSEs' 4% combined requirement[12] is less than the requirements placed on G-SIBs and community banks, even though those institutions unlike the GSEs, are able to hedge risk through investing in diversified asset classes beyond mortages. Therefore, it is essential that any proposed capital framework have a minimum leverage ratio requirement as a backup to the risk-based capital rules.

Maintaining a specified amount of capital alone will not be able to fully offset the effects of losses particularly threatening to institutions like GSEs who do not have means of diversification. While we mentioned the threats of having too little capital, there are equal drawbacks to maintaining too much. If a sticky risk-averse capital requirement as in a pure leverage ratio is set too high, it can encourage a regulated institution to take on greater risks, and neglect lower-risk business that serves the health of markets, and can help stabilize the business through economic cycles. The more capital GSEs keep on hand to cover reasonable risks, the less they have to promote market expansion and earn profits through new investments. A high intensive capital regime could harm the competitiveness and safety of the market. The increase in broad-based equity capital through the leverage ratio and other capital requirements can only work if CRTs as afforded adequate capital credit so that they can effectively draw down the risk levels of the Enterprises to mitigate the likelihood of loss.

While we support the proposed leverage minimum and believe it could safely be higher, ATR also insists this requirement be phased in over a period of several years. This onramp will give the Enterprises time to carefully increase capital on hand while developing and improving means to manage risk prudently under the changing circumstances of an exit from conservatorship.

CREDIT RISK TRANSFERS

ATR recognizes the significant benefit the CRT program has provided to the Enterprises and by extension taxpayers since its inception in 2013. CRT transactions reduce taxpayers expsoure to considerable housing market uncertainties. The transfers under the program have made it possible to shift the Enterprises' credit risk from a first-

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[8] Layton, "Demystifying GSE Credit Risk Transfer Part I," page 1.
[9] "Basel III Leverage Ratio Framework – Executive Summary," https://www.bis.org/fsi/fsisummaries/b3_lrf.pdf
[10] FDIC "Risk Management Manual of Examination Policies," https://www.fdic.gov/regulations/safety/manual/section2-1.pdf
[11] "FACT SHEET: Overview of the Community Bank Leverage Ratio Framework" https://www.fdic.gov/regulations/resources/cbi/cblr-facts.pdf
[12] FHFA, "Fact Sheet: Re-Proposed Rule On Enterprise Capital," page 3. https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/FS.pdf

loss to a last-loss position, which strengthens their soundness in a hypothetical downturn, reducing the potential burden on taxpayers from prolonged housing stress, leaving them better situated to support the market.[13] Regular CRT issuance also serves as an important price discovery mechanism. By pooling diverse sources of private capital in underwriting mortage credit risk, a number of market participants are incented to keep a close watch on potential risks in the mortage market. Through continued issuances of CRT, the Enterprises will be able to maintain these benefits while limiting their own risks as they continue to serving their mission to foster a strong secondary mortgage market without risking taxpayer-contributed capital, or exposing taxpayers to further bailouts.

CRTs effectively serve as a private capital buffer to protect taxpayers from the underlying credit risks. The Enterprises transfer most of their mortgage risk off their balance sheets by selling the credit risk of mortgage pools to investors in exchange for regular payments on that security.[14] The Enterprises categorize their assets into three tiers, Senior, Mezzanine, and First-loss, which correspond to the risk level of the underlying assets. First-loss comprises the riskiest mortgage loans that are below the investment-grade rating, while senior-level is the safest rated of the mortgage loans. Mezzanine is composed of investment-grade mortgages between the ratings of AA and BBB. After CRT, all of the senior-level and a majority of the most risky layer remain held by the Enterprises, ensuring their commitment to backstop the mortgage market and support affordable housing.[15]

Done prudently, consumers and industry participants alike benefit through the CRT program. Taxpayers especially benefit, who will have less exposure to the credit risks that GSEs assume in their operations. This effectiveness in risk management is the reason the CRT program has been expanded to apply to 70% of new credit risk on mortgages purchased by the Enterprises.[16] CRT has grown to become so prominent a part of the GSEs' business models that a swift cut of future transfers could pose a threat to the mortgage market and the risk profile of the GSEs.[17] As such, we advise calibrating capital requirments in a way that would preserve a robust CRT market in order to support the continued stability, efficiency, and transparancy of the Enterprises operation.

Financial institutions that participate in these transfers earn compensation for holding the credit risk of the Enterprises, which are protected from a portion losses if the underlying mortgages default. The Enterprises make premium payments to institutional investors holding the credit risk of the mortgage loan pool in exchange for the coverage of losses up to a certain point. The contract triggers at a minimum and expires at a

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[13] Fannie Mae (FNMA) Form 10-K, 2019, page 85. https://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2019/q42019.pdf
[14] Freddie Mac, "About CRT," https://crt.freddiemac.com/about-crt.aspx.
[15] FHFA 2019 Report to Congres, page iii.
[16] Don Layton, "Demystifying GSE Credit Risk Transfer Part III – Special Interests and Politicization," July 2020, Page 4. https://www.jchs.harvard.edu//research-areas/working-papers/demystifying-gse-credit-risk-transfer-part-iii-%E2%80%93-special-interests-and
[17] Layton, "Demystifying GSE Credit Risk Transfer Part III," page 4.

maximum percentage of mortgage defaults that varies by CRT type.[18] In this structure, private capital markets bear the first part of credit risk loss, shielding the Enterprises.

Proponents of the CRT program assert it was a key driver of the GSEs' success post-crisis and are optimistic that it will be a central component of their success post-conservatorship. While the success of the program within conservatorship for both Enterprises is indisputable, the path toward independence must also include capital buffers and ratio requirements like the Agency proposed. The rule impacts the extent to which CRT can be effectively exchanged and thus limits the amount of credit risk drawn down through this program. ATR would be concerned if the CRT program were phased out completely since market participants including first-time home buyers have benefitted from the effects of the program. In addition to an onramp of the binding leverage requirement, FHFA should furnish a study of how it expects any projected decrease in CRT will strengthen the Enterprises in the event of a downturn post-conservatorship.

INCREASE ACCESS TO CONSUMER INFORMATION

During times of economic stress, consumers, businesses and investors look for ways to preserve capital and the mortgage market is no different. Financial institutions that provide mortgages can find themselves constrained while trying to balance the need of retaining liquidity in the market and preserving capital to protect against future loses as the economic outlook appears uncertain. For credit-worthy borrowers with enough credit to meet mortgage requirements, an economy under stress could result in borrowers being turned away from a mortgage, even if the borrower would otherwise meet the requirements for a mortgage in a prosperous economic environment.

It is important for the mortgage market to continue to remain functional in a countercyclical market as it does in a pro-cyclical one. For lenders, having greater access to analytical data during the credit underwriting process will enhance the lenders intelligence to predict a borrower's ability to handle economic stress and continue to meet their mortgage-loan obligations. For example, analytical data beyond a consumer's credit score such as their use of credit, the duration of the credit and the amount of credit lines a customer uses are non-traditional ways of measuring credit and can be helpful during the credit underwriting process to improve a lender's ability to measure a borrowers credit-worthiness. Additionally, the amount of capital in savings or other bank accounts could help indicate a borrower's ability to withstand economic stress and continue to meet their loan obligations. This could also serve to bring borrowers into the mortgage market who might not have a traditional source of income, like independent contractors or barrowers with careers or investments in the sharing economy. If lenders are able to continue to extend capital even through times of economic stress it can help stimulate and speed up the economic recovery, rather than

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[18] Fannie Mae's CRT Program: https://www.fanniemae.com/portal/funding-the-market/credit-risk/credit-insurance.html. Freddie Mac's CRT Program: https://crt.freddiemac.com/offerings/acis.aspx.

holding capital on their books and not putting it to work.[19] For lenders, this would help create new streams of income to help offset losses from other borrowers unable to meet their loan requirements

Investors who participate in the CRT program through GSE bond purchases or the reinsurance market also benefit from enhanced credit underwriting. If enhanced analytical information were built into the credit underwriting process, investors could better price the underlying financial product to account for the borrower's risk profile. In other words, stress-resilient borrowers and those that are less than resilient would command applicable market prices. In times of market stress, investors could move to increase their exposure to more stress-resilient borrowers, thus increasing their pool of investment, while the GSEs retain their role of providing liquidity to the broad mortgage market and ensuring many first-time home buyers are still able to achieve their dream of purchasing their first home.

By increasing the access of consumer analytical information during the credit underwriting process can help better serve borrowers, lenders and investors who participate in the CRT or reinsurance market. If lenders and investors are able to enhance their ability to price-in risk, they can better spread the risk throughout their loan and investment portfolios and continue to invest in the mortgage market throughout times of economic stress.

I would like to thank the Agency for taking the proactive measure to propose these new capital requirements. The safety and soundness of the Enterprises is not only a crucial matter to the FHFA and Enterprises, but the broader American economy and the taxpayer. Careful, practical solutions with an eye toward what works in the marketplace are essential to the success of the Enterprises' shift out of conservatorship and the continued fulfillment of the Agency's mission. We applaud the Agency's commitment to these priciples in its proposed rulemaking.

If you should have any questions or comments, please contact me or James Setterlund by phone, (202) 785–0266, or email, jsetterlund@atr.org.

Sincerely,

Grover G. Norquist
President, Americans for Tax Reform

[19] Charles Capone Jr. "Credit Risk, Capital, and Federal Housing Administration Mortgage Insurance," in *Journal of Housing Research, Vol. 11 No. 2* (2000), 374. https://0-www-jstor-org.library.hillsdale.edu/stable/pdf/24833790.pdf?ab_segments=0%252Fbasic_SYC-5187_SYC-5188%252F5188&refreqid=excelsior%3Af5908bbdb4d82609e9a0791f85289038