FHFA's Re-Proposed Rule on a New Enterprise Regulatory Capital Framework

A comment letter from U.S. Mortgage Insurers

August 2020

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Table of Contents

Overarching Concerns 4

Recommendations 7

Specific Issues/Concerns with Capital Proposed in NPR 9

The Rule Continues to be Procyclical 29

Leverage Ratio Should Not Be Binding Ab Initio 32

Role of the New Capital Framework During Conservatorship 33

Conclusion 34

Appendix A 35

Appendix B 51

Appendix C 53

Appendix D 57

Appendix E 59

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August 31, 2020

Mr. Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
400 Seventh Street, SW
Washington, D.C. 20219

RE: Enterprise Regulatory Capital Framework
Comments/RIN 2590–AA95

Dear Mr. Pollard:

This letter is submitted by U.S. Mortgage Insurers (USMI), a trade association comprised of the leading private mortgage insurance (MI) companies in the United States. Together, the private mortgage insurance industry has helped more than 33 million homeowners achieve sustainable home ownership over the past 60 years, including more than 1.3 million in the past year alone.

USMI is dedicated to a housing finance system backed by private capital that enables access to housing finance for all creditworthy borrowers while protecting taxpayers. USMI supports meaningful and appropriate capital requirements for Fannie Mae and Freddie Mac (the Enterprises or GSEs) and appreciates the Federal Housing Finance Agency (FHFA) for initiating this rulemaking process, and for affording us an opportunity to submit comments.

We are writing today because the Enterprises play a critical role in providing affordable mortgage finance, as well as standardization that much of the conventional mortgage market relies upon. Coupled with mortgage insurance, the Enterprises make it possible for millions of consumers that do not have sufficient resources to meet high down payment requirements to nevertheless obtain reasonably priced mortgage loans and become homeowners.

While sufficient levels of capital are important to the safe and sound operation of the Enterprises, excessive capital requirements have a detrimental effect on mortgage availability and costs and can perversely push mortgage lending outside of the GSE mortgage channel. Thus, it is very important that minimum capital requirements are balanced, analytically justified both in terms of the models used and the assumptions made, and importantly, that the requirements be suited for the unique role that the Enterprises serve in the marketplace.

FHFA issued a prior proposal for changing the risk-based capital framework for the Enterprises in 2018 (2018 NPR). We submitted a detailed comment letter with respect to the prior NPR and note with appreciation that a number of the suggestions we made in that comment letter were addressed

in this new proposal.[1] Yet, there were other important issues and concerns raised in our 2018 letter that were not addressed, and there are new provisions in this NPR that create the potential for negative outcomes and/or unintended consequences. This comment letter will point out where we believe modifications in the proposed regulation will result in a more appropriate balance between taxpayer protection and support for the housing markets, consistent with the Enterprises' charters and unique role in the mortgage finance system. We will also address a number of the specific questions raised in the NPR in Appendix A to this letter.

Prior to discussing specific concerns with this proposal, we want to emphasize that a revised capital standard is only one element in the eventual reform of the Enterprises. The FHFA should use its considerable authority, both as the regulator and conservator, to take steps to ensure that the Enterprises are appropriately regulated and do not cross the bright line between primary and secondary mortgage markets.[2] Specifically, we believe that the Enterprises should be subject to utility-like regulation, with capped rates of return, restricted to explicitly authorized secondary market activities, and with open transparent underwriting engines and systems, and publicly disclosed pricing. This utility-like regulatory model should be imposed prior to the release of the Enterprises from conservatorship and remain in place until more comprehensive legislative reforms can be enacted. In Appendix B we provide more details on how a utility-like framework could function, as well as a copy of our testimony before the Senate Committee on Banking, Housing, and Urban Affairs on this subject.

[1] For your convenience we are providing our 2018 comment letter as an Attachment to this document, and request that our 2018 letter to be considered in this rulemaking.
[2] For example, the FHFA can achieve these goals through new regulations, a consent order, or subsequent amendments to the Preferred Stock Purchase Agreements (PSPAs).

I. Overarching Concerns

We begin this letter with a discussion of the key public policies that we believe should be the touchstones for the final capital framework and why we believe modifications in the NPR will further those public policy goals.

A. Capital Requirements Should Be Transparent and Analytically Justified

The regulatory capital requirements should be transparent and analytically justified. The public and affected industry participants should be able to understand the basis for particular risk-weights, haircuts and other elements of the proposal. Models used to determine these factors should be fully disclosed and based on historical data. Transparency provides credibility for the rule's requirements, and an ability for the public to identify errors and to suggest improvements in the methods and models. Unfortunately, the NPR does not provide the necessary information to determine the rationale behind many of the initial capital charges, the haircuts percentages, and other factors.[3] Further, it establishes completely subjective standards regarding creditworthiness and mortgage risk concentration of counterparties. A far better approach would be to use the existing Private Mortgage Insurer Eligibility Requirements (PMIERs)—the only rigorous set of transparent capital and operational standards for Enterprise counterparties—as a standard for creditworthiness, with no haircut for PMIERs compliant counterparties.

B. Insurance Capital Framework Should Be Used for Insurance Risks

The risk-based insurance capital framework developed by the National Association of Insurance Commissioners (NAIC) is the appropriate starting point for regulatory capital requirements for insurance companies. The bank capital rules are designed for a different industry with a different risk profile. Today Fannie Mae and Freddie Mac have little in common with commercial banks and are essentially large insurance companies, and the appropriate starting point should be the NAIC developed insurance risk-based framework.

C. The Regulation Should Not Preempt Eventual Congressional Reforms

We are well aware that GSE reform has been before the Congress for over 10 years, and despite a number of comprehensive proposals, no legislation has been passed. Without congressional action, it is appropriate for FHFA to take regulatory steps to ensure that the Enterprises will not present undue risks to the taxpayer when released from conservatorship. However, it is also important that FHFA's regulatory actions do not effectively preempt potential congressional reforms. For example, Congress may determine that an explicit

[3] In our prior comment letter, we noted that the lack of transparency in the 2018 NPR raised significant issues regarding compliance with the Administrative Procedure Act. We believe that those issues remain in this NPR and reiterated our concerns about APA compliance. Please see our 2018 comment letter attached hereto for a more detailed discussion.

government backstop for catastrophic losses represents the best way to balance the public benefits provided by the Enterprises and protection of taxpayers. [4] These public benefits, which truly private companies cannot provide, include ensuring liquidity to the mortgage markets, stability for housing finance in times of economic turmoil, and standard setting for the full range of market participants, including all types of mortgage lending institutions, mortgage insurance companies, and other private sector housing finance participants. [5]

Congress has the responsibility of taking these factors into account and providing a legislative solution that recognizes both the public benefits and risks of the Enterprises. FHFA should not impede the flexibility of Congress to address the future of the housing market by assuming that the Enterprises will continue in their present form and without an explicit government guarantee, at least for catastrophic risks.

D. Capital Requirements Must Be Balanced

Capital requirements for the Enterprises must be balanced, taking into account the impact of higher capital on housing finance and the risks to the taxpayer of the Enterprises' activities. We are concerned that the NPR fails this standard by requiring capital levels that are significantly higher than necessary even under a severely stressed scenario. This upsets the required balance by greatly impeding the ability of the Enterprises to fulfill their public policy missions in order to obtain de minimums, if any, additional taxpayer protection. As a result of not achieving an appropriate balance between capital and risk, the capital proposal will result in unnecessarily higher costs for mortgages and less mortgage availability, as higher capital requirements necessitate higher profits to support the capital. For the Enterprises, this will mean higher Guarantee Fees (G-Fees) to support the capital, raising the cost of homeownership for millions, with a disproportionate negative impact on lower income and underserved borrowers. [6] These borrowers, in turn, will have to rely more heavily on FHA products.

Higher regulatory capital ratio requirements can also be met by reducing asset size, which for the Enterprises means purchasing fewer mortgages for securitization. This also reduces mortgage availability and increases mortgage costs. And since riskier loans come with a higher capital charge, the most efficient way of meeting high capital requirements is to

[4] For example, last year the Treasury Department issued a white paper that envisioned an explicit and paid-for federal government guarantee of Enterprise mortgage-backed securities. U.S. Department of the Treasury, Housing Reform Plan (Sept. 2019). See also, Opening statement of Sherrod Brown, "Housing Finance Reform: Next Steps" Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, 116 Cong. 1st Sess (Sept. 10, 2019); Don Layton, "After a Decade of Debates about the Right GSE Reform Model, Are we Down to Two Choices?" Harvard University Joint Center for Housing Studies (Oct. 2019). A utility model would ensure the continued ability of the Enterprises to support the housing finance market and reduce, if not eliminate, incentives to take on risk.

[5] The FHFA, as both conservator and regulator, has the authority to swiftly direct the Enterprises to provide mortgage relief and implement nationwide forbearance and loan modifications programs. This is significantly different from the private mortgage market where lenders and servicers continue to lack uniformity in policies to address the needs of homeowners. This was most recently demonstrated by the Enterprises quick response to the economic hardships due to COVID-19, as compared to the uneven treatment afforded to non-agency loans.

[6] According to FHFA, the cost of holding capital against unexpected losses is the most significant factor in determining the size of the G-Fee. See https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GFeeReport1120914.pdf

reduce the purchase of low-down payment loans, especially those taken by first-time homebuyers and lower credit score borrowers. And since the Enterprises will have a smaller share of the mortgage market, the NPR will reduce the ability of the government to utilize the Enterprises to establish nationwide mortgage standards, and to respond to emergency situations such as the COVID-19 pandemic.

A recent Urban Institute paper concluded that the capital proposal "would have a substantial impact on the GSEs' business model, affecting how the GSEs price their guarantee and thus mortgage rates, their share of the mortgage market, and how much credit risk they take.[7] The Urban Institute analysis found that the proposal would result in both higher mortgage rates and a significant reduction in the market share of the GSEs, primarily by reducing the purchase of riskier (low down payment and lower income) loans.[8] The Urban Institute study estimates that the proposed rule would result in mortgage interest rates increasing by an average of 15 to 20 basis points while the GSEs remain in conservatorship and 30 to 35 basis points when they are released from conservatorship.

E. Capital Requirements Should Reduce Overall Risk to the Taxpayer, Not Merely Shift it to Other Government Entities

Any new capital framework should reduce overall risk to the U.S. government and not simply shift risk from the Enterprises to the FHA, or other government backed entities. But since the capital rule makes these loans more costly (in terms of capital) for the Enterprises to purchase, some borrowers will have to turn to FHA for their mortgage finance needs. As noted, the Urban Institute research indicates that the proposal will reduce the market share held by the GSEs and significantly increase the percentage of mortgages insured by the FHA.[9] In particular, this study estimates that the Enterprises would lose 10 to 14 percent of market share, with about one-third of the higher risk loans moving to FHA. Shifting more of the market to FHA would directly expose taxpayers to increased risk given these government insured loans have no private capital, such as MI, supporting them. In this way, the proposed rule would reallocate, but not decrease taxpayer risk and leaves these consumers with fewer competitive mortgage finance options. This is one of the reasons the proposal is of concern to many members of Congress and public interest organizations representing the views of minorities and lower income groups in the U.S.[10]

[7] J. Parrott, B. Ryan, and M. Zandi, FHFA's Capital Rule is a Step Backward (July 2020) at https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward_0.pdf (hereinafter "Urban Institute Study").
[8] Urban Institute Study pages 2-4: https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward_0.pdf.
[9] Urban Institute Study pages 2-4: https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward_0.pdf.
[10] Comment Letter filed by Representatives Maxine Waters, William Clay and Denny Heck (July 27, 2020): "[W]e are concerned that the people this rule would hurt the most are people of color, who bore the brunt of the foreclosure crisis that hit in the aftermath of 2008 due in no small part to discriminatory and predatory lending practices."

Other provisions in the NPR actually further diminish taxpayer protection. For example, because of the reduced capital benefit of private MI, overly punitive treatment to credit risk transfer (CRT), and the floors on mortgage exposures, the Enterprises will be less incentivized to de-risk in the future, further exposing taxpayers.

F. The Credit Risk-Based Capital Framework Should Be as Sensitive to Credit Risk as Possible

A credit risk adjusted framework should be as sensitive to credit risk as possible. A truly sensitive risk-adjusted capital framework will reward the Enterprises for taking steps to reduce credit risk through proportionate capital relief. Such a framework would likewise discourage increased risk taking through proportionately higher capital charges. If the changes in capital charges are not truly sensitive to the changes in the economic risk of the Enterprises, the framework will have the unintended consequence of incentivizing riskier behaviors. In short, anything that dilutes risk sensitivity, and will motivate increased risk taking in order to increase earnings without an appropriate increase in capital requirements, or diminish incentives to reduce such measures that do not result in appropriate capital relief to justify their costs.

We are also concerned that the NPR dilutes the credit risk-adjusted nature of the capital framework by combing risk-adjusted capital requirements with non-risk adjusted buffers and a binding non-risk adjusted leverage ratio. These non-credit risks should be dealt with outside of a credit risk rule. As a result of this mash up, the required capital amounts are significantly higher than would be required of a true risk-adjusted credit risk framework. The inclusion of non-risk adjusted factors into a risk-based standard decreases the sensitivity of the rule to changes in credit risk, and as noted above, has significant unintended consequences. There are far better ways to deal with non-credit risk than adding capital requirements to a credit risk-based standard designed for mortgage exposures.

Further, the NPR would exclude future revenue (primarily G-Fees), including revenue associated with the Enterprises' existing books of business, from counting toward the credit risk capital requirements. One of the stated purposes of the NPR is to implement a capital framework that ensures a going concern level of capital at the Enterprises, yet the NPR does not consider revenue generated by a going concern and continued operations during times of severe economic stress. Ignoring the Enterprises' future revenue is inherently inconsistent with the going concern objective of the NPR and this element of the proposed capital framework should be reconsidered.

II. Recommendations

USMI recommends that the proposed rule be modified in certain respects:

1. The capital rule should be completely transparent and analytically justified.

- FHFA should make public all of the assumptions and underlying calculations and provide an opportunity for interested parties to understand the basis for the rule and submit comments.
- There are layers upon layers of over-conservatism laced throughout the proposed rule. The current proposed capital levels are far above what was proposed in 2018, which also had elements of over-conservatism. The current proposal requires too much capital for the risks inherent in the Enterprises' post-financial crisis business and does not reflect the improved loan underwriting required by the Enterprises. The capital charges should be adjusted to reflect the new underwriting required by the Dodd-Frank Act.

2. *Bank Capital Model is Inappropriate for Insurance Business of Enterprises.*

- The Enterprises' primary function is that of a guarantee business, which is an insurance function, and therefore the Enterprises should be subject to an insurance capital framework. If necessary, adjustments can be made to account for systemic risk.

3. *The risk-adjusted capital rule should be based on credit risk.*

- The risk-adjusted capital rule should be as risk sensitive as possible. Elements in the risk-adjusted rule that reduce risk sensitivity should be removed or made more risk sensitive. The capital added for non-credit risks, such as interest rate risk, global warming risks, and hypothetical political risk should be deleted. These non-credit risk concerns should be dealt with through separate regulatory requirements, such as the recently adopted liquidity standard, through an operational risk requirement, or through supervisory oversight.
- The exclusion of future revenue on the Enterprises' existing books of business from the capital available to meet the credit risk capital requirements should be reconsidered. The NPR explicitly states that the capital framework is intended to ensure the Enterprises have going concern levels of capital and, accordingly, the framework should recognize and give credit for the Enterprises' revenue.
- The leverage ratio is a backstop for unusual circumstances. It should not be set so high as to be the binding capital requirement at the initiation of a new risk-adjusted framework. It should also be calculated in a manner that reflects the mortgage risk actually held by the Enterprises and recognizes the credit risk that is transferred to other market participants. Specifically, it should be based on GAAP assets with an adjustment for credit risk that has been transferred to third parties, for example, through private MI or CRT.
- The mark-to-market loan-to-value (MTMLTV) ratios do not appropriately capture regional bubbles and can have a dramatic impact on capital required. FHFA should modify the rule so that the countercyclical adjustments for single-family mortgage exposures are based on original LTV (OLTV) for the first 36-60 months, after which MTMLTV could be used.

- The buffers should be based on risk-adjusted assets. The minimum 15 percent floor creates a dramatic increase in the overall capital required for all single-family mortgages and should be removed. The minimum 10 percent floor on CRT will make CRT uneconomical and should be removed.

4. *Treatment of counterparties should be transparent and objective and therefore should be reevaluated.*

Private MI

- The proposed regulation includes a completely subjective determination of counterparty creditworthiness and mortgage risk concentration. Counterparties that meet the requirements of PMIERs should not be subject to additional measures of creditworthiness and the credit enhancement they provide should not be subject to a haircut.
- The single-family risk multipliers and credit enhancement multipliers should be revised in certain respects.
- The MI multiplier on seasoned loans with cancellable MI needs to be re-calibrated to distinguish loans in which the MI has actually been cancelled and loans that are still covered by MI, notwithstanding the 80 percent and 78 percent triggers.
- In addition to the procyclical and overly conservative effects that the proposed 15 percent risk weight floor and MTMLTV requirements have on overall capital, they also have significant, and presumably unintended consequences on the benefit that Enterprises attain from this source of important underwriting and capital standing in a first-loss position. As previously stated, the 15 percent risk weight floor should be removed. The MTMLTV requirement should be adjusted to use OLTV for 36-60 months, after which MTMLTV could be used.

CRT

- For CRT, the 10 percent floor on CRT will make CRT uneconomical and should be removed. Recommendations to ensure CRT deals meet supervisory expectations without the implementation of punitive capital treatment: (1) establish and make public a transparent model to assess the capital benefit for CRT; and (2) establish and make public a specific set of disclosures and requirements for CRT structures.

III. Specific Issues/Concerns with Capital Proposed in NPR

1. *The capital rule should be completely transparent and based on sound metrics.*

- *The Rule is a Complex Mash Up of Credit and Non-Credit Risks and Risk Weighted and Non-Risk Adjusted Factors.*

Capital requirements should be risk-based, analytically justified and based on

historical analysis, and it should be completely transparent to the market, including the models, assessments and assumptions used to arrive at the risk weights and capital levels. The NPR does not meet this standard.

The proposed risk adjusted credit risk rule continues to be an overly complex "mash-up" of different capital frameworks with many additional buffers, risk-weight floors, penalties for credit risk transfers, multipliers and haircuts, and the inclusion of non-credit risks into the credit risk calculation. The "mash-up" results in an amalgam of credit and non-credit risk concerns into a credit risk standard, thereby demanding higher amounts of capital than necessary to deal with the credit risk of mortgage exposures. Further, the proposal mixes risk-adjusted requirements with non-risk adjusted buffers, further diluting the risk-based nature of the capital requirement.

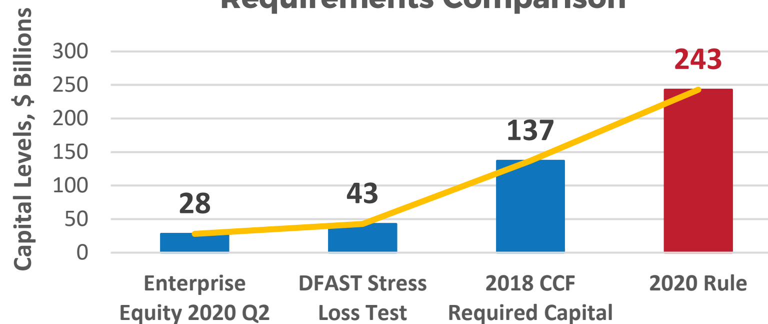
Worse yet, it appears that at the current time the leverage ratio would be the binding capital requirement, thus making the risk-based capital framework superfluous, and nullifying its use as a tool to motivate the Enterprises to reduce risk. A binding leverage ratio also eliminates any capital relief for CRT. Similarly, if the Enterprises' non-public internal models result in a binding capital ratio, as their internal models would govern, the look-up grids and tables would have no use.

- *The Rule is Overly Conservative and Would Require Significantly More Capital Than Appropriate for Mortgage Risk.*

The proposal contains layers of requirements, combining to form an overly conservative and overly complex system relying on base risk-weights, and subjectively determined multipliers and haircuts, with arbitrarily sized buffers added on to minimum calculated capital requirements. In our 2018 comment letter, we highlighted the many areas of over-conservatism that was in that proposed rule. In the 2018 NPR it was explained that the proposed capital levels were designed to cover unexpected losses, that is the difference in the amount of losses in an "expected scenario" and the losses that would occur in a severely adverse stressed scenario (i.e. the financial crisis that began in 2007). The 2018 NPR asserted that the proposed capital levels in the 2018 NPR should not result in increased G-Fees.

The 2020 NPR requires far more capital than the 2018 NPR, in the order of $100 billion.[11] If such a capital raise is successful, it would constitute the largest capital raise in history, and is nearly a 70 percent increase in capital compared to what was required under the 2018 proposal.

[11] The capital requirements of the 2020 NPR, including buffers, would require approximately $100 billion in additional capital than required under the 2018 proposal. See Table 3 at 85 Fed. Reg. 39280.



Source: USMI, FHFA

According to the NPR, the increased capital is required because the 2018 proposal was not "calibrated to ensure each Enterprise would be regarded as a viable going concern following an economic downturn that potentially entails even more unexpected losses."[12] The NPR speculates that additional capital is needed because in the future there may be "less or no Federal support of the economy."[13] The NPR also contemplates that in a future crisis there might be "less or no reduction in interest rates." Another example given in the NPR is that losses might be more severe because of changes in foreclosure laws or mitigation requirements. Additional capital is required, according to the NPR, because there is always risk of losses due to natural disasters on top of mortgage credit risk, including: flooding, earthquakes, other natural disasters or radiological or biological hazards, as well as risks related to climate change.[14] Finally, the NPR justifies additional capital (beyond the level of the 2018 NPR) on a generalized concern about "model risk," that is, the "underestimation of credit losses."

According to the NPR, this additional capital is required even though the loan products that caused much of the losses starting in 2007 are no longer being purchased by the Enterprises.[15] However, the NPR states that it must "guard against potential future relaxation of underwriting standards and regulatory oversight over those underwriting standards."[16]

In other words, the NPR takes the position that after determining unexpected losses based on a "severely adverse" stress test, and after presumably using the best statistical models and evidence available to determine the amount of capital needed to

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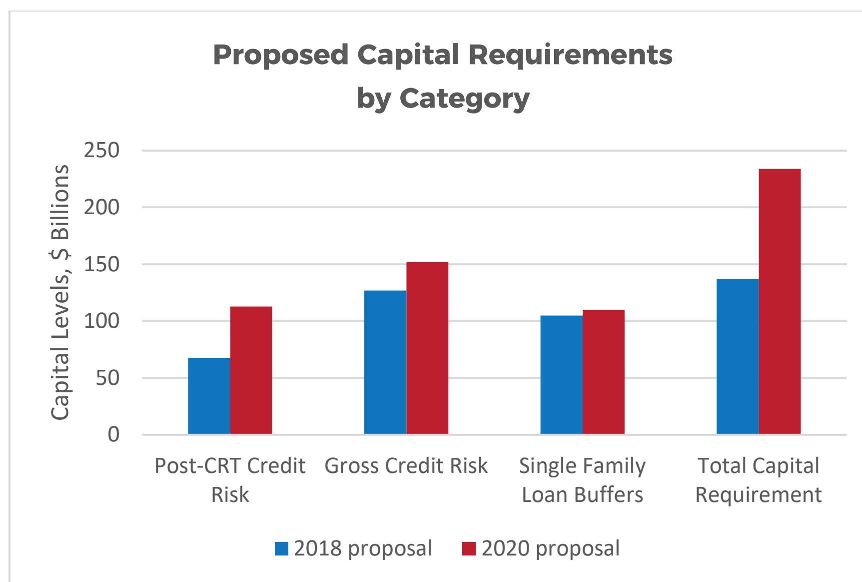
[12] 85 Fed. Reg. 39294. Emphasis added.
[13] Id. See also discussion beginning at 85 Fed. Reg. 39319.
[14] Id.
[15] Id.
[16] 85 Fed. Reg. 39294. One could argue that holding capital based on the possibility of future relaxation of underwriting standards could have the unintended consequence of encouraging such relaxation. For example, a company already holding capital for risker loans may well be motivated to purchase these products in order to obtain higher yield that these products offer.

protect against unexpected risk, the resulting capital requirement is insufficient. It is insufficient because of agency speculation that some event might occur, no matter how unlikely, to make the losses more severe. The FHFA concludes by arguing that even if the government does support the general economy in a crisis, and even if interest rates decline, some other factor could cause losses to be more severe than would be predicted based on historic data and the 2018 models.

FHFA has calculated that, if the Proposed Rule were in effect as of September 30, 2019, the Enterprises would have been required to hold $234 billion in total capital, or about $100 billion more than would have been required under the 2018 proposal.[17] In 2018, FHFA argued that the 2018 proposed rule was expected to have a neutral impact on G-Fees. Clearly by increasing the capital requirements by 70 percent, the Enterprises will have to increase G-Fees and/or shrink.



Source: USMI, FHFA

As acknowledged by FHFA, the cost of holding capital against unexpected losses is the most significant factor in determining the size of the G-Fee.[18] Therefore, the NPR, if adopted, would result in a large increase in G-Fees, or a decrease in assets and market share, or most likely, both.[19]

2. Bank capital model is inappropriate for insurance business of Enterprises.

[17] This includes the required buffers. While technically not a capital requirement, as a practical matter an Enterprise that falls below required buffer amounts would likely face severe market consequences. Thus, the buffer is, as a practical matter, a minimum capital requirement.
[18] See https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GFeeReport1120914.pdf
[19] This view is widely acknowledged. See footnotes 6 and 9 and sources cited therein.

The basic risk-based capital required for insuring against the same type of insurance risk should be the same, whether the risk is held in a traditional insurance company, a mortgage insurance company, or other insurance entity such as the Enterprises. To the extent that a company presents systemic risks to the financial system, additional capital or buffers may be required beyond this basic risk-based capital. It is also possible that other situations may justify additional capital protection. But in order to prevent unfair competitive advantages and market arbitrage, the case for requiring such additional capital should be clear and explicit.

The concept of equal amounts of capital for the same risk certainly does not justify using bank capital rules to determine appropriate levels of capital for the Enterprises, because the bank business model is different than the Enterprises' business model and because the risks assumed by banking organizations are not the same as the risks assumed by the Enterprises. Banks are financial intermediaries that originate and service various types of loans, are funded by deposits and short-term borrowings, and must deal with liquidity risk, interest rate risk, and credit risk. Banks are exposed to credit risk from both collateralized and uncollateralized loans, and thus have a far higher credit risk profile than the Enterprises. The Enterprises have very little in common with banking organizations. As established by legislation, both their stated purpose and charter requirements demonstrate that the Enterprises are different from banks. Fannie Mae and Freddie Mac were created solely to support the secondary mortgage market, and not to perform banking functions such as accepting deposits, originating commercial and consumer loans, and assuming interest rate, foreign exchange, or assorted other risks. Pursuant to their charters, the Enterprises are essentially very large insurance companies providing guarantees for mortgage-backed securities that they assemble and issue. The holders of these securities assume all of the interest rate risk. And since the Enterprises have been required to reduce their own holdings of mortgage backed securities, their liquidity or rollover risk is also minor.[20]

As stated in a recent Urban Institute paper:[21]

> *The FHFA's attempt to shoehorn the GSEs into a bank-like capital regime would exact a heavy cost on the mortgage market. It would drive up mortgage rates, increase the incentive the GSEs have to take on credit risk, and decrease their incentive to off-load that risk. In effect, it would take us to a more expensive, excessively capitalized version of the housing finance system we had prior to the financial crisis.*

[20] See, e.g. L. Goodman, J. Parrot, and M. Zandi, The Trump Administration's Perplexing Plans for Fannie and Freddie (Oct. 29) ("Bank lenders are required to hold more capital for their mortgage lending—generally closer to a 5% capitalization, though it varies by bank—because they bear more risk on these loans. GSEs bear only the credit risk, whereas bank lenders bear the interest rate risk and significant funding risk.")

[21] Urban Institute Study at 5.

The NPR would result in an overall capital charge for the Enterprises of approximately 4 percent, after including buffers. This 4 percent level is equivalent to the minimum risk-based capital requirement for first mortgage exposures under the Basel Standardized approach. But it is much more than the capital charge that would be expected under the more accurate and nuanced Basel Advanced approach for a mortgage loan that meets the Enterprises' underwriting standards.

The Basel Standardized approach does not attempt to fine tune capital with risk, but instead uses broad and arbitrary risk weights to create minimum capital requirements for these institutions. The Basel rule's 50 percent risk weight for first mortgage loans is not based on an analytical study of mortgage risk, but was established in 1988 as a way to provide some recognition that a collateralized mortgage loan is safer that an unsecured loan to a small or mid-sized business or an unsecured credit card loan to a consumer. Likewise, the Basel rule uses a 100 percent risk weight for corporate loans, personal loans, and other exposures, whether or not collateralized, and a 20 percent risk weight for insured banks, regardless of their financial strength. The Basel Standardized approach is simply not a sophisticated approach to setting capital, and the NPR's reliance on the Basel Standardized approach for the two highly sophisticated Enterprises—which are more akin to insurance companies—is misguided.

The NAIC's risk-based capital rule, on the other hand, is designed for companies like the Enterprises that are providing insurance protection in which both risks and required capital can be quantified. The NAIC framework can be used to require capital levels that will protect the Enterprises against losses in a severely distressed environment, based on analytics that more accurately estimate necessary capital and risks.[22]

The NPR argues that the bank capital framework should be applied because the Enterprises, like the banks, are dependent upon short-term funding. The NPR notes that the Enterprises were required to obtain and rollover significant amounts of short-term funding ($345 billion in 2010), and that such funding will not be available if capital levels do not support "going concern" operations.

Interestingly, the 2018 NPR came to a different conclusion. That NPR specifically stated that the Enterprises do not face the short-term funding or "rollover risk" faced by banks with respect to their guaranty business (as opposed to their retained portfolios and cash window operations).[23] The 2018 NPR indicated that funding or rollover risk was related

[22] As noted in a Federal Reserve Board and NAIC Joint Report to Congress: "Banking and insurance industry supervisor use very different approaches for identifying and addressing exposures to risk and losses, and to setting regulatory capital charges. The divergent approaches arise from fundamental differences between the two industries, including the types of primary risk they manage, the tools they use to measure and manage those risks, and the general time horizons associated with exposures from their primary activities."

[23] The 2018 NPR explained: "[B]banks rely on more volatile funding sources compared to the Enterprises, which exposes banks to a greater degree of funding risk during times of market and economic stress…. By comparison, the Enterprises' core credit guaranty business of purchasing and

to the large retained portfolio held by the Enterprises in 2008. Since that time the ability of the Enterprises to retain a portfolio of mortgage securities or loans has been significantly restricted,[24] and therefore so has the rollover risk.

We agree with FHFA that the Enterprises must be strong enough to remain going concerns during a financial crisis. As noted above, the insurance capital rules provided going concern protection during the Great Recession more successfully than the banking rules. Further, Congress may address this concern through authorization of an explicit backstop against catastrophic losses, which was recommended by Secretary Mnuchin earlier this year.[25] Such a backstop would alleviate much of the concern that the markets would refuse to roll over the Enterprises' short-term debt, or that the Enterprises would cease to function during a financial crisis more severe than the 2008 experience. As explained previously, and as discussed at length in the recent Congressional Budget Office Effects of Recapping Fannie Mae and Freddie Mac Through Administrative Actions,[26] this NPR may well be "jumping the gun" by not waiting for Congress to determine if, and how the federal government will stand behind the Enterprises, and thus reduce or eliminate rollover risk.

Further, rollover or liquidity risk can and should be addressed in other ways than requiring bank-like capital. If FHFA believes that over reliance on short term debt is a safety and soundness issue, the agency has more than enough authority to require changes. In fact, recent SEC filings made by the Enterprises indicate that these entities will be required to comply with minimum liquidity requirements that are more stringent than the liquidity standards imposed on large banks.[27] In light of this development, the purported justification for using bank-like capital is eliminated, and FHFA should revert to an insurance capital framework.

In summary, the Enterprises' primary function is that of a guarantee business, which is an insurance function, and should be subject to an insurance capital framework. If necessary, adjustments can be made to account for systemic risk. The NPR already includes a stress capital buffer designed to maintain the Enterprises as going concerns during financial crises. The other rationale cited in the NPR for the use of bank-like standards, liquidity risk, has been much diminished by the reduction in the Enterprises' retained portfolio, and by the development of a liquidity standard that is expected to be mandatory as of September 1,

securitizing mortgage loans provides a more stable source of funding that cannot be withdrawn during periods of market and economic stress and is therefore not subject to rollover risk." 83 Fed. Reg. 33323.

[24] Section 1109 of Housing and Economic Recovery Act of 2006; 12 C.F.R. 1252.1.

[25] Dexheimer, Elizabeth. "Fannie-Freddie May Be Freed With Treasury Backstop, Mnuchin Says," *Bloomberg* (February 20, 2020)*:* https://www.bloomberg.com/news/articles/2020-02-20/fannie-freddie-may-be-freed-with-treasury-backstop-mnuchin-says.

[26] Congressional Budget Office, "Effects of Recapitalizing Fannie Mae and Freddie Mac Through Administrative Actions" (August 2020): https://www.cbo.gov/system/files/2020-08/56496-GSE.pdf.https://www.cbo.gov/system/files/2020-08/56496-GSE.pdf.

[27] Fannie Mae and Freddie Mac 10-Qs Filings.

2020. There is simply no need to use a bank-like standard in light of these developments, and certainly no need to look to the Basel Standardized approach as a baseline.

3. *The risk-adjusted capital rule should be based on credit risk.*

- *Risks Used to Justify Higher Capital are Not Credit Risks*

The issues raised in the NPR justifying higher capital, including the 15 percent risk-weight floor on residential mortgages, are not "credit risks" but are actually political risk (the government will abandon the economy) or interest rate risk (that interest rates will not go lower during a financial panic) or natural disaster risk (the risk of earthquake, floods, or global warming) or legal risk (the foreclosure laws will change). The NPR makes a fundamental mistake by using these hypothesized catastrophes in building a credit risk model that should be based on the performance of mortgage assets in different economic cycles, and not on the potential impact of earthquakes. If capital rules were to be based on all potential risks, no capital requirement less than 100 percent would be sufficient. It is for that reason that a credit risk capital requirement is limited to credit risks, and other risks are dealt with through an operational risk requirement, a liquidity risk mandate, and for various other risks, supervisory oversight.[28]

Another way to view this proposal is that it seeks to require the Enterprises to hold capital against catastrophic risk. This is well beyond unexpected losses. In the Basel framework, unexpected losses are not determined through speculation, but rather through a statistical analysis of historical losses. In the 2018 NPR, unexpected losses were computed by simulating the economic conditions of the financial crisis that began in 2007 in order to determine required capital. This proposal, on the other hand, bases estimates of unexpected losses (and thus capital requirements) on speculative scenarios that go far beyond even the financial crisis. This appears to be an attempt to provide for catastrophic risk protection, which is not the asserted purpose of the NPR.[29] It could also be viewed as an attempt to resolve the public policy debate regarding the need and size of a Federal backstop for the Enterprises. It is questionable whether this can or should be resolved through regulatory, as opposed to congressional action.

Finally, to the extent that FHFA seeks to protect against model risk or other uncertainties, the appropriate answer should be found in the leverage ratio, not in the credit risk capital requirement. The leverage ratio establishes a non-risk adjusted backstop, so that even if the models have errors, an appropriate minimum level of capital

[28] In this regard we note that the NPR includes a separate capital charge for operational risk, modeled on the Basel operational risk capital charge but with a floor equal to 15 basis points of adjusted total assets. Both the NPR and Basel operational risk charge are explicitly designed to consider risks relating to the operations of the Enterprises through such things as natural disasters, business disruptions, fraud, and damages to physical assets. The operational risk capital charge recognizes risk mitigation techniques, including insurance protection.

[29] A number of legislative proposals have been made with respect to the impact of catastrophic risk on the Enterprises, and arguably this is a subject for Congress to address. See, e.g. The Housing Reform and Taxpayer Protection Act, S.1217 113th Cong. (2013).

will nevertheless be mandated. In fact, the NPR adds a 1.5 percent buffer to the leverage ratio explicitly to ensure that it would be a backstop for the risk-based capital requirements.[30] We have serious concerns with a leverage ratio that is the binding capital constraint at the initiation of a new risk-based capital framework, but we agree that it serves as a backstop to protect against model risk. However, an appropriately sized leverage ratio will address concerns about model risk, without the need to add yet another non-risk sensitive layer to the risk-based capital framework.

- *Rule Should Consider Revenue on Existing Book of Business*

The proposal states that it does not count any future revenue (primarily G-Fees), including revenue on the existing book of business, toward the credit risk capital requirement, other than the stress capital buffer.[31] However, the NPR states that the capital framework is intended to ensure a going concern level of capital. If going concern protection is the objective of the proposed rule, logically it should also consider the income generated by a going concern, at least with respect to the currently booked assets. In other words, since the goal of the new framework is to allow the Enterprises to continue in business during a time of severe economic stress, then the rule should recognize that as a going concern the Enterprises are going to continue to generate revenue. Ignoring revenue is simply inconsistent with the going concern objective of the proposal.[32]

- *Base Credit Risk Grids Increased without Justification Based on Risk*

In the 2020 proposed rule, the base credit risk grids are increased for all borrowers compared to the 2018 proposed rule. For borrowers that have not had substantial time or means to accumulate a significant down payment, these higher (>80 percent) loan-to-value ratio (LTV) loan borrowers will face an even greater increase in the capital charge for their loans—more than 30 percent increase compared to the 2018 proposed rule. The base risk weights[33] are significantly higher as the LTV increases for borrowers with the same credit score. For example, the base risk weight for a borrower with a 710-credit score increases from 57 percent to 110 percent when the LTV increases from 80 percent to 96 percent. This will result in a significantly higher capital charge for low down payment loans, which will be especially harmful to first time homebuyers, minorities and lower income individuals.

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[30] According to the NPR: "The primary purpose of the leverage ratio requirements is 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". 85 Fed. Reg. 39294.

[31] 85 Fed. Reg. 39291.

[32] This is not an insignificant factor. During the five years when Fannie's losses were at their highest (2008-2012), its post-2007 book of business grew to $1.9 trillion; guarantee fees on that new book through 2012 totaled $15 billion, with credit losses less than $2 billion.]

[33] As listed in Table 9 on p.112 and Table 2, paragraph (c)(1) on p.345 of the 2020 proposed rule.

And this increase/change is before the 15 percent floor kicks in, which makes the capital levels even higher.

Percent Increase in Base Credit Risk Grids from 2018 Rule to 2020 Rule for Higher LTV Loans[34]

% Increase New Rule/ Old Rule (FICO Credit Score)	80.01-85% LTV	85.01-90% LTV	90.01-95% LTV
<620	32%	33%	33%
>=620, < 640	32%	33%	32%
>=640, < 660	33%	33%	33%
>=660, < 680	33%	33%	32%
>=680, < 700	32%	33%	33%
>=700, < 720	33%	33%	33%
>=720, < 740	33%	32%	33%
>=740, < 760	31%	33%	32%
>=760, < 780	31%	31%	32%
>= 780	35%	32%	33%

Source: USMI, FHFA

- *15 Percent Floor on Mortgage Risk is Inappropriate*

The proposed rule has a 15 percent floor on the risk weight for residential mortgage loans, regardless of the risk weight that otherwise would be assigned based on loan characteristics and historic data. Thus, even if the models developed by FHFA indicate that the loan should only have a 5 percent risk weight, under the proposed rule the mortgage will nevertheless be assigned a 15 percent risk weight. This provision alone will increase required capital for each Enterprise by as much as 30 percent from the 2018 rule, which was itself also overly conservative.[35]

The NPR justifies the 15 percent floor, and 30 percent increase in average risk weight, on several grounds. First, it notes that without the floor, the NPR would have required less capital in 2007 than the cumulative losses on the single-family loans from 2007 until 2011.[36]

[34] The 2018 proposed rule contained separate tables of base credit risk weights for new and seasoned loans (Tables 9 and 10, respectively). In the 2020 re-proposed rule, these were combined into one. Further, additional changes such as the consideration of multiple borrowers versus a single borrower were included in the 2020 Proposed Rule. The increases shown in this table measure the comparison between Table 9 in the 2018 rule and Table 9 in the 2020 rule.

[35] Applying the 2018 framework to the Enterprises' September 30, 2019 book of business, the average risk weight on the Enterprises' single-family mortgage exposures would have been approximately 20%, while the average RWA under the proposed capital framework would be 26% (a 30% rise in capital requirements), with the increase primarily driven by the 15% risk weight.

[36] 85 Fed. Reg. 39319.

This assumes, of course, that neither Enterprise would have taken steps to increase capital during that 4-year period. It also ignores the fact that the overwhelming majority of losses that began in 2007 were due to high risk mortgage loans that would not have met the mortgage lending standards introduced as part of the Dodd-Frank Act[37] and that are no longer eligible for acquisition by the Enterprises.[38]

Further, comparing required capital under the new rule based on the Enterprises' much safer current exposures with total cumulative losses in the 2007-2011 era is not a meaningful metric. The more accurate and informative metric would be a comparison of capital required under the proposal based on the Enterprises' single-family mortgage portfolio as of 2007, and the losses suffered during the following four years. In other words, how much capital would the new proposal have required if it had been in place in 2007? That is the relevant number. We urge the FHFA to consider undertaking this analysis before finalizing any capital rule.

The NPR also rationalizes the need for a 15 percent floor on speculative concerns about the potential for: model error, the return of lax underwriting standards, government failure to provide economic assistance in a financial crisis, the economic consequences of earthquakes, flooding and climate change, etc.[39] We explained above why these speculative factors should not be included in a credit risk-based capital framework.

In short, the 15 percent floor is an arbitrary limit that is based on a faulty comparison with cumulative losses that occurred on a much riskier pool of assets, that ignores the risk reduction impact of the new capital framework, and that attempts to add capital for speculative concerns that are not even credit risk. The 15 percent floor applied to all mortgages, regardless of how strong the borrower credit is, is a "blunt instrument" approach of arriving at an overall capital number that is not grounded in the changes that have occurred post crisis, is risk-insensitive and not analytically justified based on historical analysis. The goal of protecting the Enterprises from all conceivable risks is inconsistent with the goal of having a strong and liquid secondary mortgage market and would have an immediate adverse impact on consumers. We therefore recommend that the 15 percent floor be dropped in the final rule.

4. *Treatment of counterparties should be transparent and objective. Therefore, counterparty treatment should be reevaluated.*

[37] See, Minimum Standards for Mortgages, Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203 (2010) §§ 1411 et. seq.
[38] For example, the Fannie Mae will not purchase: mortgages with an interest-only feature; graduated-payment mortgages, including growing-equity mortgages; mortgages originated with stated or no income and/or asset documentation (high LTV refinances are not covered by this provision); mortgages subject to negative amortization; construction mortgages (other than construction-to-permanent);daily simple interest mortgages; mortgages with prepayment penalties; reverse mortgages; mortgages with balloon payments (with or without a reset option); and second liens or other junior mortgages. See, https://selling-guide.fanniemae.com/Selling-Guide/Doing-Business-with-Fannie-Mae/#Overview
[39] 85 Fed. Reg. 39319—39320.

1) Private MI

- *The Proposed Rule Fails to Accurately Value Mortgage Insurance*

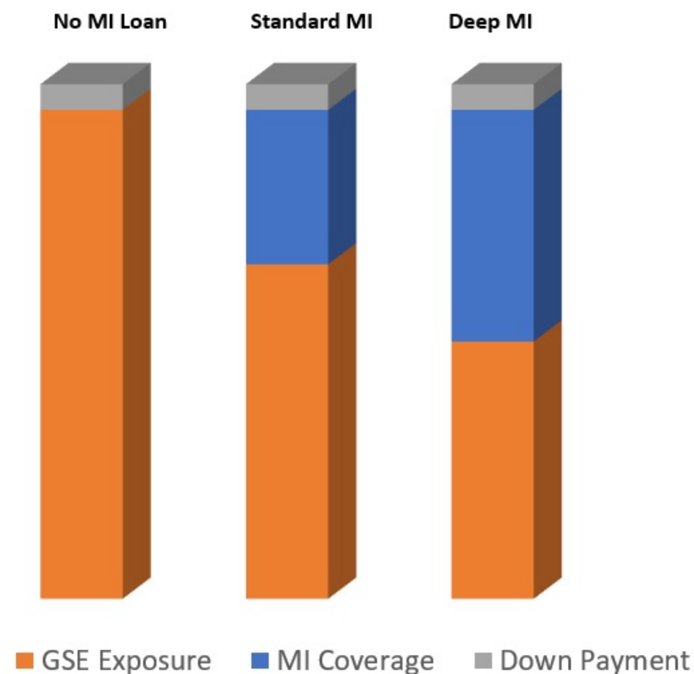
A. Capital Relief for Mortgage Insurance Should Be Objectively Determined, Consistent with Historical Data

Loan level credit enhancement, in the form of mortgage insurance, puts private capital ahead of both the Enterprises and the taxpayer. Since private MI companies independently underwrite the loans that they insure, they serve as a second pair of eyes, and thereby reduce risk in the overall system. Private MIs are sources of "permanent capital," meaning they are available to assume first loss credit risk throughout market cycles. Since the financial crisis, the MI industry has evolved into a more proactive and sophisticated "aggregate-manage-distribute" operating model by laying off credit risk through capital markets transactions and reinsurance. However, when these markets are not available, private MI continues to hold capital against this first-loss risk. This function is critical to ensuring that the Enterprises and taxpayers are protected through mortgage cycles, and equally important, that borrowers continue to have access to low down payment financing through the conventional markets. It is therefore critically important that mortgage insurance receive appropriate, statistically determined, and objective treatment under the proposed capital framework. Unfortunately, this is not the case.

In our 2018 comment letter, we explained that based on historic data, the CE Multipliers for guide-level and charter-level coverages should be 0.469 and 0.717 respectively, which is significantly lower than the CE Multipliers of 0.845 and 0.916, respectively, proposed in the 2018 rule. The 2020 proposed rule retains the same CE Multipliers as the 2018 version (Tables 15 – 19). This needs to be corrected. USMI has included detailed analysis of counterparty treatment in the 2018 and 2020 proposed rules in Appendix C, and more information can also be found in our linked 2018 comment letter.

We are also concerned the 2020 proposal codifies only charter level and guide level coverage and does not contemplate MI coverage that could go beyond those two levels. There is no question that deeper insurance protection continues to reduce loss in the event of a default, and this increased benefit can be statistically determined through an analysis of available data. This reduction in loss reduces risk and should be recognized in any risk-based capital framework.

DEEP COVERAGE MORTGAGE INSURANCE Coverage and Exposures Compared to Standard Coverage				
LTV	Standard Coverage		Deep Coverage	
	Coverage Percentage	Exposure Down-To	Coverage Percentage	Exposure Down-To
85%	12.0%	74.8%	41.2%	50.0%
90%	25.0%	67.5%	44.4%	50.0%
95%	30.0%	66.5%	47.4%	50.0%
97%	35.0%	63.1%	48.5%	50.0%



Source: USMI

To the extent that deeper MI protection provides for meaningful risk reduction, which can be determined, there is no reason not to increase the accuracy of the proposal by considering MI coverage beyond guide level.

- *Definition of "Approved" Insurer*

The 2020 NPR provides different levels of capital relief depending upon whether the mortgage insurance company is "approved" by the Enterprise to guarantee mortgage loans.[40]

[40] See proposed rule at §1240.33(a)("Approved insurer means an insurance company that is currently approved by an Enterprise to guarantee or insure single-family mortgage exposures acquired by the Enterprise.")

While we agree that it is an important distinction to be an approved versus non-approved entity, the reference is somewhat confusing in that it appears capital relief, albeit at a reduced level, will be afforded for mortgage insurance provided by a counterparty that is not approved by the Enterprise. This does not make sense.

The only formally designated standard to be an "approved" insurance company is the PMIERs of the Enterprises. [41] This document includes not only minimum capital and other financial standards, but also operational and quality control requirements, conflict of interest restrictions, and mandated procedures. We do not believe that any company that is not in compliance with PMIERs should be an acceptable counterparty. And, consistent with the high standards contained in PMIERs, we believe that any company that satisfies PMIERs requirements should be considered an "Approved Insurer." Finally, as discussed below, in light of the high capital and credit standards included in PMIERs, there is no justification for the imposition of a counterparty credit risk haircut for PMIERs compliant insures.

- *Determination of Creditworthiness and Concentration in Mortgage Risk*

As with the 2018 NPR, this proposal applies a counterparty's haircut based on a subjective determination, by the Enterprises, of counterparty creditworthiness and counterparty concentration in mortgage credit risk. These are subjective determinations that permit the Enterprises to essentially pick "winners and losers" without public disclosure of the basis for these determinations. Secret and subjective determinations of this nature have the potential of causing great harm to the Enterprises and to the housing markets—and are solely inappropriate for the Enterprises if they are released from conservatorship and potentially competing against other private companies. And the secret nature of these ratings is fundamentally unfair in that counterparties have no visibility as to how to improve their Enterprise-determined creditworthiness rating.

Instead, the new capital framework should provide transparent and objective benchmarks set by the Enterprises, but approved by FHFA, for making determinations regarding creditworthiness and concentration. The Enterprises currently use PMIERs to ensure mortgage insurance company counterparty creditworthiness, as well as providing minimum standards for operations, procedures, conflict of interest and other controls. No other Enterprise counterparty has this same transparent and rigorous set of both capital and operational standards. As FHFA and the Enterprises have the ability to modify, and have in

[41] PMIERs. "The Private Mortgage Insurer Eligibility Requirements (PMIERs) establish the requirements that a private mortgage insurance company must meet to be an approved insurer eligible to write mortgage guaranty insurance selected by a mortgage enterprise, for mortgages acquired by Freddie Mac pursuant to the Freddie Mac Single-Family Seller/Servicer Guide. This document is intended solely for the use of approved insurers and applicants for approved insurer status. For the avoidance of doubt, the PMIERs are not intended to have the effect of regulation, which is expressly the domain of regulators, but, rather, they set forth requirements an approved insurer must meet and maintain in order to provide mortgage guaranty insurance on mortgages acquired by Freddie Mac. This document contains requirements as well as guidelines associated with applying for, obtaining, and maintaining Freddie Mac approved insurer status, which status is determined in Freddie Mac's sole and absolute discretion. Approved insurers must meet requirements that are preceded by the term "must."" Page 3 PMIERs.
https://sf.freddiemac.com/content/_assets/resources/pdf/requirements/pmiers.pdf

practice made modifications, to these standards over the years, any counterparty that meets these rigorous standards should not be subject to a significant counterparty haircut for credit risk.[42] In fact, as a matter of logic, as long as the risk-based capital requirements for MI companies are consistent with the risk-based capital requirements for the Enterprises no counterparty risk haircut for credit risk is warranted. For other forms of CRT that have counterparty credit risk, we recommend that the FHFA follow the lead of Solvency II and publish a more credible model of counterparty risk for reinsurers, including a table of objective criteria that determines risk grade assignments—that are equivalent from a capital perspective as PMIERs are for MIs.

The NPR also increases the haircut for counterparties that are deemed to be "highly" concentrated in mortgage risk without defining that term or providing any parameters for determining what is a "high" concentration. For example, a monoline insurance company may not be "highly" concentrated if it engages in transactions that transfer significant mortgage credit risks to other parties. And a company that appears to be diversified, may in fact be highly concentrated in mortgage credit risk because it assumes that risk through derivative transactions or other investments.

Further, the NPR appears to assume that a monoline insurance company is less creditworthy than a diversified company. However, monoline mortgage insurance companies are dedicated to the housing market and are experienced in understanding, dealing with, and surviving the entire credit cycle. They have detailed expertise and experience in mortgage risks and risk mitigation and may be more appropriate (and safer) insurance providers than diversified companies that lack this expertise. This expertise and commitment to mortgage credit is a significant benefit to both the Enterprises and to the mortgage finance system. Entities that provide this expertise to underwrite and actively manage mortgage credit risk should also receive the appropriate capital relief for also engaging in credit risk transfer when these markets are available. FHFA should not assume that a diversified company provides a better counterparty without considering these offsetting factors.

Finally, other elements, including both the MTMLTV requirement and the 15 percent risk weight floor, which are unrelated to MI, can have a significant, and presumably unintended consequences, on the capital benefit the Enterprises should receive from first-loss credit protection of private MI. This in turn could considerably diminish good risk management by the Enterprises. The minimum 15 percent risk weight floor on single family mortgages will reduce the capital benefit of MI when the net capital required under the proposed rule would otherwise be below the 15 percent minimum floor. This could create a

[42] As noted above, any amendments to PMIERS should be implemented only after required public notice and comment to ensure that such amendments.

perverse incentive for an Enterprise to forgo the appropriate level of credit risk mitigation provided by loan level mortgage insurance simply because the capital treatment is unattractive. An example of this impact is below.

	FHFA 2018	FHFA 2020
Original LTV	97	97
MTM LTV	**75**	**75**
Loan Age (months)	72	72
FICO (original and Current)	760	760
MI Coverage	35%	35%
Loan Amt	$100,000	$100,000
Risk in Force	$35,000	$35,000
Counter Party Score	4	4
Risk Factor (FHFA Table 9/10)	1.14%	1.52%
Gross Capital %	**1.14%**	**1.52%**
Gross Capital $	**$1,140**	**$1,520**
Credit Enhance Factor (FHFA Table 16)	63.10%	63.10%
Counter Party Factor	17.20%	14.20%
CE Credit	69.40%	68.30%
Net Capital %	0.79%	1.04%
Net Capital $	**$792**	**$1,039**
Implied MI Capital Benefit $	**$348**	**$481**
15% min capital (15% * 8%)		1.20%
Net Capital $		$1,200
Gross Capital	$1,140	$1,520
Net Capital With 15% floor	$792	$1,200
Implied MI Benefit	**$348**	**$320**

MI Benefit reduced by 33% due to 15% floor

The same is true of the MTMLTV requirements, which under the proposed rule would kick-in at only six months after the loan is originated. One of the unintended consequences of this is that, in a rising house scenario, if the increase in the home's market value reduces the LTV below the 80 percent, the Enterprise would no longer receive the capital benefit for MI, though MI protection could still be on the loan until the borrower actually reaches the required equity LTV ratio for borrower-requested cancellation or automatic termination of MI, which is statutorily based on original home value[43].

- *Cancellable v. Non-Cancellable MI: The MI Multiplier on Seasoned Loans with Cancellable MI Appears Too Conservative.*

[43] Under current law, borrower paid MI can be cancelled in two ways: 1) At the request of the borrower, when the loan is scheduled to reach 80 percent of the original value, or 2) automatically when the mortgage is scheduled to reach 78% of the original value of the property. Certain other requirements must be met. 12 U.S.C. § 4902, and § 1717(b). See also, http://www.usmi.org/aboutusmi/mi-cancelability/

The NPR varies the CE multiplier for a MI insured single-family mortgage based on whether the mortgage insurance is cancellable or non-cancellable. Cancellable mortgage insurance allows for the cancellation of coverage upon a borrower's request when the unpaid principal balance falls to 80 percent or less of the original property value, or automatic cancellation when either the loan balance falls below 78 percent of the original property value or the loan reaches the midpoint of the loan's amortization schedule. However, there are exceptions to these rules. For example, borrower requested cancellation does not apply if the homeowner does not have a "good payment" history or is not current at the time of the request, or if he or she has taken out a second mortgage on the property that is outstanding.

The NPR look-up tables assign risk-weights to loans with cancellable MI that appear to assume that the MI coverage will be cancelled after a specified period of time. This lumps together mortgages in which the homeowner qualifies for either MI cancellation and mortgages in which the cancellation provisions do not apply, for example because the homeowner not current on payments or has taken out a second mortgage on the property. The proposal should therefore distinguish loans in which the MI has actually been cancelled and loans that are still covered by MI, notwithstanding the 80 percent and 78 percent triggers.

Example: A typical loan with mortgage insurance – a loan with a 720-739 credit score, 90 to 95 percent loan-to-value – that has seasoned 48 to 60 months would have a capital charge equivalent to a loan without mortgage insurance that had amortized to an 85 to 90 percent LTV.

After 60 months, a loan that started with a 95 percent LTV would have amortized to about 86 percent. That means the capital rule gives virtually **no credit for the existing mortgage insurance** on the seasoned loan. It is not reasonable to assume that all mortgage insurance on such loans would be cancelled after five years, so the result that mortgage insurance has virtually no capital value at that point seems counter intuitive at best.

*There is no analytical evidence to suggest that the credit performance of a highly seasoned loan with mortgage insurance requires **more** capital than a loan with similar seasoning and LTV but no mortgage insurance.*

2) *Credit Risk Transfer*

We support the use of **credit risk transfer (CRT)** transactions to transfer credit risk to the private sector. We appreciate that CRT transactions, even when fully collateralized, do not provide the same type and level of protection against loss as equity capital.[44] CRT should not be viewed as a goal, in and of itself, but instead should be used as a tool to transfer a

[44] 85 Fed. Reg. 39330. Among the concerns raised in the NPR is that the risk level transferred through CRT may not be "pierced" in a downturn, that the Enterprises will pay excessive fees to attract risk transfer counterparties, and that the market for risk transfer securities may evaporate during financial stresses.

meaningful amount of credit risk for an appropriate amount of compensation. For example, it is counterproductive for an Enterprise to engage in a CRT transaction where the first-loss position retained by an Enterprise essentially carries *all* of the risk of the asset. In this situation the Enterprise is paying counterparties for assuming only nominal amounts of risk, funds that could be better used to build the Enterprises' capital reserves.

These transactions increase the capacity of the Enterprises to provide liquidity to the mortgage markets and reduce the risk of the Enterprises, which reduces risk to taxpayers. As noted in a Federal Reserve Bank of New York analysis, "the CRT initiative has improved the stability of the housing finance system" and has "meaningfully reduced the Federal Government's exposure to mortgage credit risk without disrupting the liquidity or stability of secondary mortgage markets."[45] A recent report issued by J.P. Morgan also emphasized the importance of CRT:[46]

> *CRT offers several benefits for the GSEs, regulators, private entities and ultimately, the consumer. First, the sector has proven itself to be an effective risk transfer mechanism for mortgage credit risk. Since 2013, Fannie Mae and Freddie Mac have issued $87bn of CAS and STACR transactions …. Most deals are backed by new issue collateral, but there have also been deals issued using seasoned re-performing or HARP collateral…. CRT enables a wide range of global investors, from hedge funds to money managers, to act as reinsurers for all forms of GSE credit risk.*

The J.P. Morgan study noted that CRT provides valuable information about the market's pricing of mortgage credit risk through both the fees charged to initially assume the risk and the prices paid for these positions in the secondary market. This provides important information to both the Enterprises and FHFA in calibrating the level of the G-Fees. Large differences between what the market charges to accept mortgage credit risk and the amount the Enterprises charge for assuming that risk, in the form of G-Fees, is a strong indication that an adjustment should be considered.

As an industry that has been actively engaged in MI-CRT since 2015, we can also attest to the value of a robust and liquid CRT market that assumes mezzanine levels of mortgage credit risk. In Appendix D we provide more information about the credit transfer risk structures used by the MI industry and demonstrate how these transactions do meaningfully transfer credit risk to third parties as these markets are available.

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[45] D. Finkelstein, A. Strzodka, J. Vickery, "Credit Risk Transfer and De Facto GSE Reform," 24 Federal Reserve Bank of New York Economic Policy Review 88 (Dec. 2018).

[46] J.P. Morgan, You Break it You Own It: GSE Capital Framework and CRT (July 30, 2020), https://markets.jpmorgan.com/research/email/-pa5128c/-V4_mSm4bGjC_eIcpEGSWw/GPS-3447310-0

A. CRT Floors and Reversals

There are two provisions in the NPR that must be removed for CRT to be economically feasible for the Enterprises. First, the NPR imposes a risk-weight floor of 10 percent on retained security positions, even for the most senior position that is typically protected against all but the most catastrophic credit collapse. Second, the NPR provides that when credit risk is laid off to a third party through a securitization the Enterprise must nevertheless calculate its risk-weighted assets as if 10 percent of the risk sold off were still on its balance sheet. In other words, if third parties purchase $1 billion of mezzanine securities the Enterprise must "pretend" that $100 million was not effectively transferred and hold capital against this $100 million.[47]

The effect of these limitations is to "double charge" the Enterprises for reducing their credit risk. A CRT transaction has significant costs for the Enterprise. These go beyond the costs of structuring the transaction, legal fees, and administrative costs, but more significantly, the parties must be paid to assume credit risk.[48] Under the NPR, on top of this cost, is the cost of additional capital that is required by diminishing the effectiveness of the risk transfer. If the Enterprises must risk-weight a retained senior tranche at a level above the actual risk of the position, the capital is tied up and cannot be used for other, more productive purposes. This is a "cost" to the Enterprises without an offsetting benefit. Likewise, if the Enterprise must "pretend" that 10 percent of the risk transferred to third parties is nevertheless still on its books, this results again in an excess capital charge with a cost to the Enterprise. This double charging for CRT will be a significant disincentive to the use of CRT transactions. Punitive capital charges for CRT will disincentivize risk reduction and are not in the public interest.

The J.P. Morgan study noted earlier finds that the proposed rule makes CRT uneconomical for the Enterprises, due to the leverage ratio and the 10 percent risk weight floor.[49] This study explained that, with respect to the risk-adjusted rule, the 10 percent floor on even the most senior tranche of a CRT securitization effectively makes the cost of doing the typical CRT securitization more expensive than any benefit that would otherwise accrue. As stated in the study: "One of the main reasons for the low capital relief provided by CRT is the 10 percent RWA floor. This applies to the senior tranche, which is the bulk of the deal and

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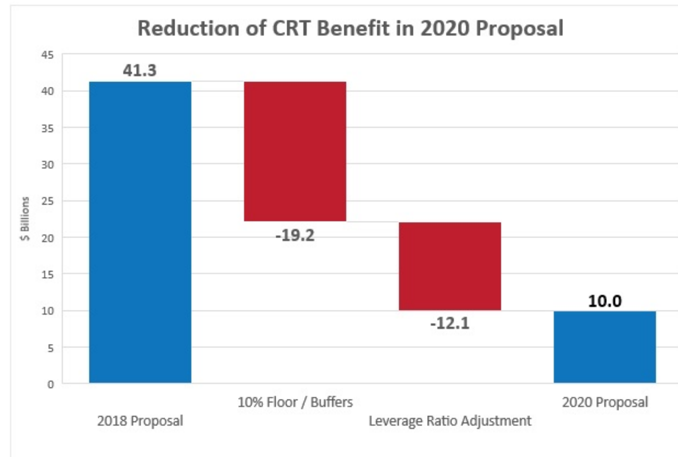
[47] According to the FHFA's own estimates, the additional capital charges and 10% risk-weight floor together cut the relief the GSEs get for CRT today roughly in half

[48] The NPR recognizes that the Enterprises must pay a portion of their income to counterparties in a CRT transaction, e.g. that there is a cost to the Enterprise for off-loading credit risk. 85 Fed. Reg. 39328.
sector investors

[49] The impact of the leverage ratio on CRT will be discussed infra.

therefore, drives the economics of the transaction. If this floor were set to 0 percent, as was the case with the 2018 capital proposal, CRT would still be economical…."[50]



Source: USMI, FHFA

A similar conclusion was reached in the Urban Institute report noting that the NPR would make CRT non-economic to transact in all but a few economic conditions, ultimately pushing the GSEs to retain 85 percent to 90 percent of their risk.[51]

The NPR already has several backstops to ensure that the Enterprises will maintain high equity capital levels, including the non-risk adjusted leverage ratio and non-risk adjusted buffers. In addition, if FHFA is concerned that the Enterprises are inappropriately using CRT to reduce their equity, or for "window dressing," the agency has sufficient regulatory authority to correct the improper practice. There is no need for an across the board 10 percent floor and 10 percent risk reversal. As noted by the Urban Institute, "By unnecessarily impairing the viability of CRTs, the FHFA's capital rule undermines the ability of the GSEs to distribute their credit risk, thus increasing their capital needs and the burden on taxpayers while they are in conservatorship."[52]

B. *Application of Transparent Standards to the Enterprises' CRT*

Based on the MI industry's experience with CRT transactions, we also recommend two additional supervisory steps that will help ensure that these transactions meet

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[50] JP Morgan, You Break it You Own It: GSE Capital Framework and CRT (July 30, 2020), https://markets.jpmorgan.com/research/email/-pa5128c/-V4_mSm4bGjC_eIcpEGSWw/GPS-3447310-0
[51] Urban Institute Study at 4.
[52] Id. at 5.

supervisory expectations without the implementation of a punitive capital treatment. These steps are:

1. Establish and make public a transparent model for assessing the capital benefit for CRT, using a number of different stress scenarios contemplated for CRT structures, including scenarios such as high run-off and high loss. The model should be able to assess any CRT structure weakness and allow the FHFA and the Enterprises to make modifications to these structures.
2. Establish and make public a specific set of disclosures and requirements, similar to what is found in Section 707 of the PMIERs. FHFA should also establish a comprehensive list of the counterparties in significant CRT transactions, including the CAS/STACR deals. This will enable FHFA and the Enterprises to determine if a particular counterparty has assumed excessive risk for transactions that are not fully collateralized.

With these recommendations, rather than the proposed capital penalties on CRT, many of the concerns raised in the NPR will be mitigated or eliminated, and the Enterprises and the taxpayers will be able to continue to benefit from the transfer of risk from the Enterprises to the private sector.

IV. The Rule Continues to be Procyclical

In our prior comment letter, we noted that the 2018 proposal would result in a procyclical risk-based capital framework in which less capital would be required in good times (and thereby fueling the expansion) and more restrictive capital requirements in bad times (and thereby reducing credit availability and hampering economic recovery). The new NPR recognizes that mitigating procyclicality is in the public interest, and would also facilitate capital management, enhance the safety of the Enterprises, and help position the Enterprises to provide stability and assistance to the national housing market across the economic cycle.[53]

The NPR suggests a number of changes made to the 2018 NPR would make this proposal less procyclical. These changes include: (i) a countercyclical adjustment to MTMLTV used to establish the base capital charge of mortgage exposures; (ii) the stress capital buffer; (iii) the leverage buffer; (iii) a floor of 15 percent on the risk-weight for mortgage exposures; and (iv) a requirement that each Enterprise maintain its own view of credit and other risks through the mandated use of internal models.[54] In addition, a "countercyclical capital buffer" could also be applied if the FHFA determines that there is "aggregate credit growth" leading to systemic risk.[55] The NPR states that the

[53] See discussion at 85 Fed. Reg. 39290.
[54] Id.
[55] 85 Fed. Reg. 39276—7. The NPR explains that the "focus on excess aggregate credit growth means the countercyclical buffer likely would be deployed on an infrequent basis, and generally only when similar buffers are deployed by the U.S. banking regulators." Id.

countercyclical capital buffer would be initially set at 0.

The assumption that the stress capital buffer or the leverage buffer are anti-cyclical is only half true. Both of these measures are based on total adjusted assets and are not risk adjusted. Therefore, in good times, with low losses, these requirements may become constraints that limit credit availability, and are therefore anti-cyclical. However, in bad times, when losses increase, these measures will restrict the ability of the Enterprises to provide credit, and therefore will be highly procyclical.

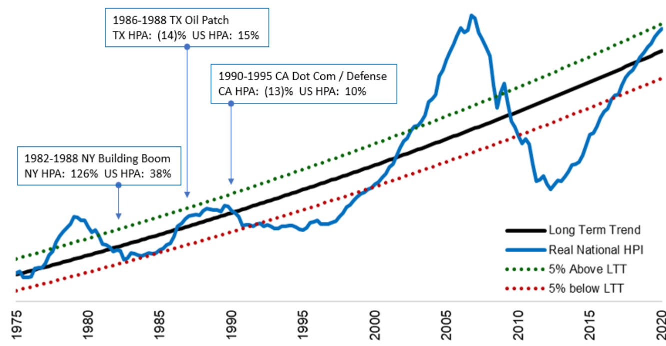
The 15 percent floor on mortgage exposures suffers the same defect. It will reduce credit availability in good times, when the look up charts would otherwise indicate a lower capital charge. But it will not increase credit availability in hard times. Further, as discussed earlier, the imposition of an arbitrary 15 percent floor has many other negative consequences from a public policy perspective.

The countercyclical adjustment to the MTMLTV helps somewhat, but it is a complex and cumbersome technique that will only come into play when the national house prices deviate by more than 5.0 percent above or below an estimated inflation-adjusted long-term trend (the "collar'). We question the use of national, rather than regional house price deviations. But more fundamentally, we believe that the correct approach is to use OLTV and not an adjusted LTV.[56] There is no certainty that the complex formula prescribed in the rule will reduce procyclicality in a meaningful manner. Five years of growth of house prices at a national level that is 4.9 percent above the long-term trend could easily be indicative of a housing price bubble but will not trigger the contemplated adjustment.[57] As demonstrated by the graph, regional housing bubbles have occurred as illustrated by several past regional housing booms and later busts that would not have been captured under the proposed approach. the sentence after the graph should be this:

[56] This concern was also raised in the Urban Institute Study, which notes at page 8 that the "countercyclical MTMLTV adjustments" may well do more harm than good." House price trends tend to vary considerably by region, with geographically constrained urban centers with fast-growing, high-paying industries often showing greater house price growth than less densely populated areas with slower-growing, lower-paying industries. Tying capital requirements, and thus mortgage cost and availability, to national house price trends will result in overly tight lending standards in some parts of the country and overly easy standards in other parts."

[57] In his comment letter submitted to the FHFA, Timothy Howard notes that "The 'collars' on market value LTVs … still subject the companies to very large increases in required capital during a severe downturn." He adds that "Unless FHFA switches to original LTVs, Fannie and Freddie would need to hold enough excess capital to cover this risk, making their effective capital requirement that much higher (in effect, a "hidden cushion")."

Nominal HPA from the FHFA All Transactions Index



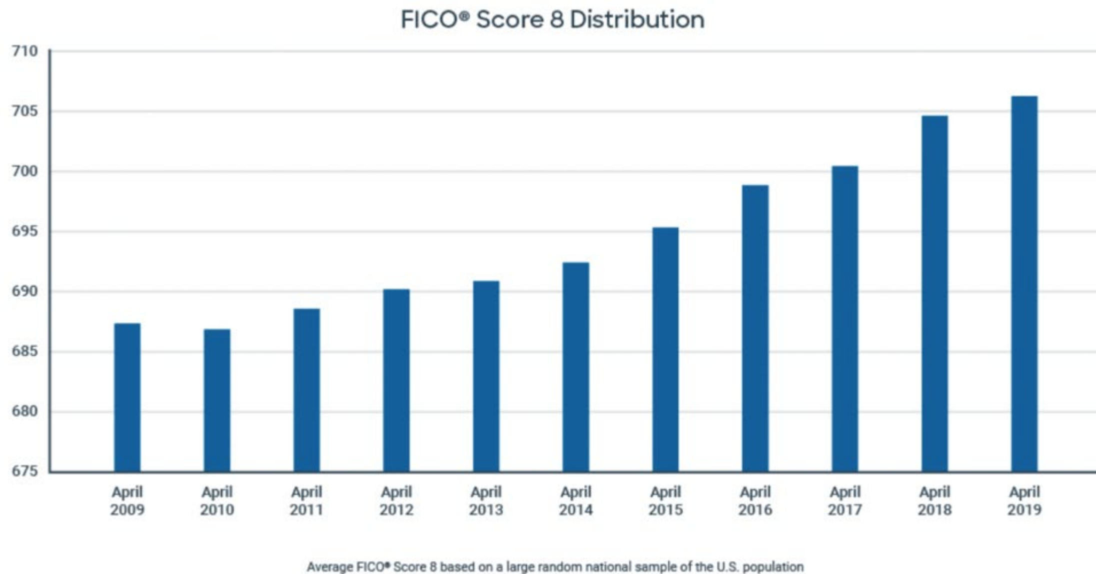
Source: USMI, FHFA

A more conservative approach that would not require the use of a complicated formula is to use OLTV.

We are also very concerned about the procyclicality of the proposed use of refreshed (updated) credit scores in setting mortgage capital requirements. Under the proposed rule, the use of refreshed scores is required after 6 payments. This single provision would have more significant procyclical effect than any other provision in the NPR and would not be offset by the other factors noted above.

For example, in 2009, in the midst of the Great Recession, the national average FICO score was 687.[58] By 2019, following the economic recovery, the average FICO score was 706.[59] For a mortgage to the "average" consumer with a MTMLTV of 90 percent, the base capital risk-weight in 2019 would be 10 percent lower than in 2009.[60]

[58] These are FICO series 8 score averages. The data can be found at https://www.fico.com/blogs/deep-dive-distribution-fico-score-across-us.
[59] Id.
[60] The base risk-weight for that loan in 2009 to the "average" consumer with a FICO score of 687 would be 98 percent. In 2019, the base risk weight for that same loan to the "average" consumer who now has a FICO score of 796, would be 88 percent. That equates to a 10 percent procyclical decrease in base risk-weight for that mortgage.



Source: FICO

This illustrates the procyclical result of using a refreshed credit score and why it should not be included in the final rule.

V. Leverage Ratio Should Not Be Binding Ab Initio

The leverage ratio is a capital charge that is not adjusted for the risk of the assets held by the Enterprises. As proposed in the NPR, it would be a flat 2.5 percent of total adjusted assets with a buffer of 1.5 percent, for a total capital requirement of 4.0 percent.

The NPR states that the leverage ratio is intended to serve as a backstop to the risk-adjusted requirement to safeguard against model risk measurement and error.[61] However, because this requirement is not adjusted for risk, it provides no incentives for the Enterprises to reduce risk. If the leverage ratio requires more capital than the risk-based requirement (the "binding constraint") it will create an incentive for the Enterprises to take on more risk (and potential earnings) until the risk-based capital becomes the binding constraint. This is because when the leverage ratio is higher than the risk-based ratio, the Enterprise pays no capital price for holding additional risk, and therefore there will be pressure to hold riskier assets to increase earnings.

Further, a binding leverage ratio dramatically reduces the usefulness of CRT. Under the NPR, the capital benefits afforded CRT accrue only to the risk-adjusted capital requirement. Therefore, no matter how successfully a CRT transaction transfers risk to a

[61] 85 Fed. Reg. 39281.

third party, it will have no impact on the leverage ratio. The Enterprises will have to pay the third party to assume the credit risk but will receive no benefit in the form of reduced capital. As a result, as long as the leverage ratio is binding, the Enterprises will have a disincentive to engage in CRT transactions. See Appendix E.

The NPR acknowledges that based on the portfolios of the Enterprises in September of 2019, the leverage ratio would require higher capital than the risk-based ratio and therefore be the binding constraint. For the reasons explained above, we believe that this indicates that the leverage ratio is set too high and will therefore have significant negative consequences for the Enterprises and the goal of safety and soundness, and that it should be reconsidered. A backstop leverage ratio should only come into play as the binding constraint during unusual market conditions, and not at the initiation of a new risk-based system.

If retained, however, the leverage ratio should be recalculated to reflect the mortgage risk actually held by the Enterprises rather than including the credit risk that is transferred to other market participants. This would be analogous to the recent temporary adjustment to bank capital rules in which Treasury securities and cash are excluded from the bank leverage ratio, as those represent other types of assets that have been effectively de-risked.

VI. Role of the New Capital Framework During Conservatorship

As noted above, the NPR states that it is intended to establish "a post conservatorship regulatory capital framework."[62] The proposed effective date for the capital requirement is the later of one year after publication of the final rule or termination of the conservatorship.[63] However, the NPR also states that one of the objectives of the proposal is to "Increase the quantity and quality of the regulatory capital of the Enterprises to ensure that, during and after conservatorship, each Enterprise operates in a safe and sound manner…."[64] And the Enterprises have to report capital levels as computed under the proposal even if they are still under conservatorship.[65]

The NPR does not explain how FHFA plans on using the new capital framework during the conservatorship. We believe that it would be a mistake to use the new capital framework to establish Enterprise G-Fee pricing. Doing so would have an immediate impact on housing finance, without the time necessary to understand how the new framework works in practice. It could also cause an immediate shock to the mortgage markets without the benefit of a transition period to adjust to these new requirements. It also assumes the Enterprises will exit from conservatorship without significant changes in

[62] 85 Fed. Reg. 39275.
[63] Proposed section 1240.4(c).
[64] 85 Fed. Reg. 39275.
[65] Proposed section 1240.4(b).

the housing finance framework and the borrowers they support. As discussed, the future role and structure of the Enterprises are topics of much discussion and congressional interest. The proposed capital regulation should not be used to adjust G-Fees prior to the determination of how the Enterprises will be structured in the future, and certainly not prior to their release from conservatorship.

VII. Conclusion

The proposed risk-based capital framework NPR illustrates the need for appropriate rules governing the activities of the Enterprises following their release from conservatorship. And we support the efforts of FHFA to bring this issue to the forefront by issuing this proposal and continuing the debate over the appropriate capital requirements for the Enterprises post-conservatorship.

In light of the extremely important and unique role played by the Enterprises in the nation's housing finance system, it is critical that regulatory capital requirements carefully balance the need to protect taxpayers from loss and the impact of increased capital mandates on mortgage costs and availability. This is particularly important to minorities, lower income individuals, and first-time homebuyers, who may be forced to use alternative (and more costly) programs, such as FHA guaranteed loans, or worse, be unable to obtain housing finance.

As explained in detail in this letter, we believe that this proposal does not strike the right balance. To achieve this balance, it is critical that the Enterprises' statutory mission to support the secondary market (which is entirely different than banks' core business function and is more an insurance function), as well as other key considerations such as those that can and should be determined by Congress about the Enterprises' future, be better considered before the finalizing the rule. As a result of not achieving this balance, the Enterprises will not be able fulfill their statutory responsibilities to the mortgage markets. Further, rather than decrease risk to the taxpayers, the likely impact will be to move the risk to FHA and other government mortgage programs that do not have private capital standing between the taxpayer and losses.

In conclusion, we believe that this NPR serves an important purpose by raising the issue of capital regulation of the Enterprises post-conservatorship, but that the proposed requirements do not represent the balanced approach necessary to avoid significant unintended consequences. We therefore recommend that FHFA revise and re-propose a new capital rule that considers the issues raised by this comment letter.

Thank you,

Lindsey Johnson
President

Appendix A

USMI Responses to Specific Questions in the 2020 NPR

Question 4. ***Is the tier 1 leverage ratio requirement appropriately sized to serve as a credible backstop to the risk-based capital requirements?***

We have serious concerns with a leverage ratio that is the binding capital constraint at the initiation of a new risk-based capital framework, but we agree that it serves as a backstop to protect against model risk. However, an appropriately sized leverage ratio will address concerns about model risk, without the need to add yet another non-risk sensitive layer to the risk- based capital framework.

The leverage ratio is a backstop for unusual circumstances. It should not be set so high as to be the binding capital requirement at the initiation of a new risk-adjusted framework.

Question 5. ***Should the Enterprise's leverage ratio requirements be based on total assets, as defined by GAAP, the Enterprise's adjusted total assets, or some other basis?***

The buffers should be based on risk-adjusted assets. The leverage ratio should be based on GAAP assets, except that it should not include credit risk that has been effectively transferred to third parties, for example, through MI or CRT.

Question 7. ***Should any of the risk-based capital requirements or leverage ratio requirements be phased-in over a transition period?***

The new capital rules should be phased in over an appropriate period of time to avoid market disruptions.

Question 12. ***Should an Enterprise's stress capital buffer be based on the Enterprise's adjusted total assets or risk-weighted assets?***

Since the buffers, unlike the leverage ratio, are components of a risk-adjusted capital framework, they should be based on risk-adjusted assets.

Question 13. ***Is the countercyclical capital buffer appropriately formulated?***

The countercyclical capital buffer implemented by FHFA when it determines that there is excess

aggregate credit growth sufficient to indicate that there is a build-up of systemwide risk. This is the same approach taken by the banking regulators. However, the Enterprises have a far different risk profile than the banks, and while a build-up of systemwide risk is an appropriate metric for the banking industry, it may not be for the Enterprises. We suggest that the countercyclical capital buffer for the Enterprises be based on an excessive build up in housing credit, rather than a standard looking at the entire economy.

Question 16. ***Is the market share approach appropriately formulated and calibrated to mitigate the national housing finance market stability risk posed by an Enterprise? If not, what modifications should FHFA consider to ensure an appropriate calibration?***

No. Capital regulation should not be driven by market share goals or triggers.

As proposed the market share approach will create an incentive to reduce market share of outstanding residential mortgage debt. This will result in the growth of FHA market share, increasing risks to taxpayers. It will also have a negative impact on housing costs since fixed costs will have to be spread among a smaller number of borrowers. Finally, if the Enterprises are reduced in size it will be more difficult for the government to be able to use these entities for standard setting and facilitating public policy.

Question 17. *Is the market share approach appropriately formulated and calibrated to ensure each Enterprise operates in a safe and sound manner? If not, what modifications should FHFA consider to ensure an appropriate calibration?*

No. A separate stability buffer is not necessary if the risk-based capital standard is appropriately formulated.

Further, limited market share does not ensure better regulation—in fact it may do the opposite. While it is a significant unanswered question as to if Congress will ever enact legislation to allow FHFA to charter other guarantors, given the unique statutory charters, mission and businesses of the GSEs, rather than limiting their market share, it is likely far better for FHFA to regulate the two Enterprises with utility-like regulation to ensure their safety and soundness. See more in Appendix B.

Question 18. ***Should the Enterprise-specific stability capital buffer be determined using the U.S. banking framework's approach to calculating capital surcharges for GSIBs?***

No. See answers to Questions 16 & 17.

Question 19. ***What, if any, modifications to the U.S. banking framework's approach to calculating capital surcharges for GSIBs are appropriate for determining the Enterprise-specific stability capital buffer?***

The banking framework for GSIBs is not appropriate for the Enterprises and should not be used. Stability should be dealt with through an appropriately formulated risk-based capital standard.

Question 20. ***Should the Enterprise-specific stability capital buffer be determined based on a sum of the weighted indicators for size, interconnectedness, and substitutability under the U.S. banking framework?***

No. See answers to Questions 16-19.

Question 21. ***Which, if any, indicators of the housing finance market stability risk posed by an Enterprise, other than its market share, should be used to size the Enterprise's stability capital buffer? How should those other indicators be measured and weighted to produce a score of the housing finance market stability risk posed by an Enterprise?***

No. See answers to Questions 16-19.

Question 22. ***What, if any, measure of the Enterprise's short-term debt funding or expected debt issuances during a financial stress to fund purchases of NPLs out of securitization pools should be used to size the Enterprise's stability capital buffer?***

No. See answers to Questions 16-19.

Question 23. ***Is the PLBA appropriately sized to backstop the PCCBA-adjusted risked-based capital requirements?***

The application of bank-centric capital principles does not align with the GSEs' core business activity - guarantying mortgage credit risk - which is more akin to insurance. This 4.0 percent leverage ratio (flat 2.5 percent of total adjusted assets with a 1.5 percent buffer) acts as a binding constraint for the GSEs in their Tier 1 capital against their total adjusted assets. It will be binding most often in good economic times when the leverage ratio is higher than the capital required under the risked-based framework. The application of the proposed PLBA raises questions concerning the relevancy of the risk-based framework if it is ultimately not the framework and capital levels that will often apply to the GSEs. It

will also create an incentive for the Enterprises to increase their risks until the risk-based capital charge equals the 4.0 percent leverage charge. It is therefore counterproductive.

Question 30. ***Is the methodology used to calibrate the credit risk capital requirements for single-family mortgage exposures appropriate to ensure that the exposure is backed by capital sufficient to absorb the lifetime unexpected losses incurred on single-family mortgage exposures experiencing a shock to house prices similar to that observed during the 2008 financial crisis?***

Comparing required capital under the new rule based on the Enterprises much safer current exposures with total cumulative losses in the 2007-2011 era is not a meaningful metric. The more accurate and informative metric would be a comparison of capital required under the proposal based on the Enterprises' single-family mortgage portfolio as of 2007, and the losses suffered during the following four years. In other words, how much capital would the new proposal have required if it were in place in 2007? That is the relevant number. We urge the FHFA to consider undertaking this analysis before finalizing any capital rule. Further, the re-proposed rule also ignores the fact that the overwhelming majority of losses that began in 2007 were due to high risk mortgage loans that would not have met the mortgage lending standards introduced as part of the Dodd-Frank Act[66] and are no longer eligible for acquisition by the Enterprises.[67]

These decline and recovery assumptions are inappropriate since they fail to recognize dramatic improvements throughout the housing finance system as a result of the Dodd-Frank Act, underwriting guardrails implemented under the Ability To Repay/Qualified Mortgage Rule (ATR/QM Rule), and increased capital held by industry participants, including private mortgage insurers.

Further, the re-proposed rule further dilutes the ability of the Enterprises to appropriately use and distribute mortgage credit risk private capital with the introduction of the minimum 15 percent risk weight floor. The impact of the 15 percent floor negates the full capital benefit that should otherwise be realized from private MI (see example below). Any adjustment for counterparty risk is clearly made through the counterparty haircuts already applied to private MIs. This additional reduction in capital benefit is clearly an unintended consequence. The GSEs should not be penalized for sharing that risk

[66] See, Minimum Standards for Mortgages, Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203 (2010) §§ 1411 et. seq.

[67] For example, the Fannie Mae will not purchase: mortgages with an interest-only feature; graduated-payment mortgages, including growing-equity mortgages; mortgages originated with stated or no income and/or asset documentation (high LTV refinances are not covered by this provision); mortgages subject to negative amortization; construction mortgages (other than construction-to-permanent);daily simple interest mortgages; mortgages with prepayment penalties; reverse mortgages; mortgages with balloon payments (with or without a reset option); and second liens or other junior mortgages. See, https://selling-guide.fanniemae.com/Selling-Guide/Doing-Business-with-Fannie-Mae/#Overview

with private entities that underwrite, manage, distribute and hold significant capital against that risk—in fact, they should be incentivized to further distribute first-loss credit risk this risk to private MIs .

Question 31. ***What, if any, changes should FHFA consider to the methodology for calibrating credit risk capital requirements for single-family mortgage exposures?***

It is critical that regulatory capital charges for the Enterprises be risk-based, transparent, and analytically justified. Industry participants and consumers should be provided with the models, assumptions, and historical data necessary to understand the FHFA's basis for the specific risk-weights, haircuts, and other elements of the proposal. Transparency would provide credibility for the proposed rule's requirements and the ability for stakeholders to identify errors and submit recommendations to the improve the proposal's components.

Question 32. ***Are the base risk weights for single-family mortgage exposures appropriately formulated and calibrated to require credit risk capital sufficient to ensure each Enterprise operates in a safe and sound manner and is positioned to fulfill its statutory mission across the economic cycle?***

The proposed rule reflects increases in the base risk weights for single family mortgage exposures (Table 9)[68] over the requirements set forth in the FHFA's 2018 proposal. The increases across all LTV/FICO buckets will significantly impact low down payment borrowers. The proposal lacks the precise model and other information used to develop the base risk-weight, making it difficult to comment on the assumptions used by FHFA to develop the proposed rule. Refer to pages 17-18 for more details.

Question 34. ***Should the base risk weight for a single-family mortgage exposure be assigned based on OLTV or MTMLTV of the single-family mortgage exposure, or perhaps on the LTV of the single-family mortgage exposure based on the original purchase price and after adjusting for any paydowns of the original principal balance?***

The use of MTMLTV ratios would result in a procyclical risk-based capital framework that has the potential to accelerate housing bubbles and contract mortgage credit availability during downturns. It would require less capital in during good economic conditions, thereby fueling the expansion, and require significant more capital during bad economic conditions, thereby reducing credit availability

[68] The 2018 proposed rule contained separate tables (Tables 9 and 10) of base credit risk weights for new and seasoned loans (using OLTV and MTMLTV, respectively). In the 2020 re-proposed rule, these were combined into one which uses MTMLTV. The increases shown in this table measure the comparison between Table 10 in the 2018 rule and Table 9 in the 2020 rule as both use MTMLTV.

and dampening economic recovery. While the proposed rule tries to counteract the procyclical nature of MTMLTV with the application of a countercyclical collar adjustment based on national house prices, a more effective approach would be to use OLTV for 36 to 60 months after which FHFA could use national or regional MTMLTV house price deviations.

Question 35. ***Should the base risk weight for a single-family mortgage exposure be assigned based on the original credit score of the borrower or the refreshed credit score of the borrower?***

The use of refreshed FICO credit scores is inherently procyclical and could materially impact consumers' access to mortgage credit. Under the proposed use of refreshed credit scores, capital requirements would decrease during economic booms and the Enterprises would not be preparing for future negative events. Further, during downturns when credit scores decline, capital requirements would increase and there would be a tightening in mortgage credit. The use of refreshed credit scores can have the most significant procyclical effect and, unlike the MTMLTV countercyclical collar adjustments, the proposed rule does not include an offset or element to counteract the procyclical nature of refreshed credit scores.

Question 36. ***What steps, including any process for soliciting public comment on an ongoing basis, should FHFA take to ensure that the single- family grids and the real house price trend are updated from time to time as market conditions evolve?***

It is critical that FHFA have both formal and informal processes to receive feedback from industry stakeholders to assess market conditions and how various aspects of the rule operate in real life.

Question 37. ***Should a delinquency associated with a COVID-19-related forbearance cause a single-family mortgage exposure to become an NPL?***

No, delinquencies associated with COVID-19 forbearances should not result in an NPL until it has been determined that the borrower is no longer in forbearance because they have either become current or defaulted. There should also be a distinction between "true" credit events, which can be modeled and estimated, and. local and national systemic shocks which create temporary disturbances in homeowners' ability to pay. In those cases, policymakers will minimize the economic harm to the Enterprises by ringfencing certain borrowers. Data from the Mortgage Bankers Association (MBA) and Black Knight demonstrates that approximately 25 percent (more than 1 million households) of homeowners in active COVID-19 related forbearance plans remain current on their monthly mortgage payments and many more are making partial payments.[69]

[69] Mortgage Bankers Association, Weekly Forbearance and Call Volume Surveys; Black Knight, Inc., Mortgage Monitor Reports.

Question 38. ***Which, if any, types of forbearances, payment plans, or modifications should be excluded from those that cause a single- family mortgage exposure to become a modified RPL? Should a forbearance, payment plan, or modification arising out of a COVID-19-related forbearance request cause a single-family mortgage exposure to become a modified RPL?***

Delinquencies associated with natural disasters, including COVID-19 forbearances, should be excluded from those that cause a single-family mortgage exposure to become a modified RPL. These loans should be treated as natural disaster or COVID-19 related forbearance, and should have an incremental capital requirement, such as that outlined under PMIERs[70] Table 8, footnote 1, until it has been determined that the borrower is no longer in forbearance because they have either become current or defaulted.

Congress has indicated that it agrees that these borrowers should not be negatively impacted as they have recently legislated that borrowers in COVID-19 forbearance should not have negative credit reporting due to COVID-19 impacts. Section 4021 of the "Coronavirus Aid, Relief, and Economic Security Act" (CARES Act) requires that furnishers of information to credit reporting agencies report mortgages in COVID-19 forbearances as "current" or as the status reported prior to the forbearance (unless the homeowner becomes current).

Question 39. ***Is the MTMLTV adjustment appropriately formulated and calibrated to require credit risk capital sufficient to ensure each Enterprise operates in a safe and sound manner and is positioned to fulfill its statutory mission across the economic cycle? If not, what modifications should FHFA consider to ensure an appropriate formulation and calibration?***

The 5 percent collar is designed to address the procyclical effect of MTMLTV ratios but the most effective and streamlined way would be to use OLTV ratios. It is unnecessary and inappropriate to lean so heavily on yet another adjustment that will not even take regional price changes into account. The use of MTMLTV ratios has the potential to accelerate housing bubbles and contract mortgage credit availability during downturns. If the FHFA retains the 5 percent collar, it should require the Enterprises to use OLTV for 36 to 60 months, after which they could use national regional MTMLTV house price deviations.

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[70] Private Mortgage Insurer Eligibility Requirements (PMIERs), Exhibit A (Risk-Based Required Asset Amount Factors), Table 8 (Non-Performing Loans), footnote 1 applies a 0.30 multiplier to the risk-based required asset amount factor for each non-performing primary mortgage guaranty insurance loan backed by specific properties that are in forbearance under specific terms. This footnote was amended in PMIERs Guidance 2020-01 that became effective on June 30, 2020. The PMIERs Guidance 2020-01 also specifically amends table 8 (Non-Performing Loans) of PMIERs temporarily to add a multiplier for specific COVID-19 impacted loans. PMIERs is found at http://www.freddiemac.com/singlefamily/pdf/PMIERs.pdf and the PMIERS Guidance 2020-01 is found at https://singlefamily.fanniemae.com/media/23266/display.

Question 40. ***Does the MTMLTV adjustment strike an appropriate balance in mitigating the pro-cyclicality of the aggregate risk-based capital requirements while preserving a mortgage risk-sensitive framework? Are the collars set appropriately at 5.0 percent above or below the long-term index trend?***

The use of MTMLTV ratios would result in a procyclical risk-based capital framework that has the potential to accelerate housing bubbles and contract mortgage credit availability during downturns. It would require less capital in during good economic conditions, thereby fueling the expansion, and require significant more capital during bad economic conditions, thereby reducing credit availability and dampening economic recovery. While the proposed rule tries to counteract the procyclical nature of MTMLTV with the application of a countercyclical collar adjustment based on national house prices, a more effective approach would be to use OLTV for 36 to 60 months after which FHFA could use national or regional MTMLTV house price deviations.

Question 41. ***How should the long-term house price trend be determined for the purpose of any countercyclical adjustment to a single-family mortgage exposure's credit risk capital requirement?***

The FHFA and Enterprises should use the FHFA House Price Index (HPI) for determining the applicability of any countercyclical adjustment. The HPI is a longstanding and easily accessible index that includes data on national, regional, state, and MSA home prices that would prove useful if the final rule relies on national or regional house price deviations.

Question 42. ***Are the risk multipliers for single-family mortgage exposures appropriately formulated and calibrated to require credit risk capital sufficient to ensure each Enterprise operates in a safe and sound manner and is positioned to fulfill its statutory mission across the economic cycle?***

The NPR states that the base risk weights and risk multipliers were calibrated using the Enterprises' internal models and the FHFA's publicly available model, presumably the model described in the white paper. The Enterprises internal models, however, are not publicly available and the NPR does not provide the necessary information to determine if the base risk weights are justified. The FHFA should make the model(s) and all other relevant information available to stakeholders to facilitate a comprehensive review of the risk multipliers for single-family mortgage exposures.

Question 44. ***Should the combined risk multiplier for a single-family mortgage exposure be subject to a cap (e.g., 3.0, as contemplated by the 2018 proposal)?***

Based on the capital requirements formula, the individual elements used to calculate loan-specific capital requirements could have a snowball effect and produce large capital charges on a loan by loan basis. A cap is worth exploring as a means to ensure borrowers are not priced out of the conventional market.

Question 45. ***Are the CE multipliers and CP haircut multipliers for single-family mortgage exposures appropriately formulated and calibrated to require credit risk capital sufficient to ensure each Enterprise operates in a safe and sound manner and is positioned to fulfill its statutory mission across the economic cycle?***

As previously stated, all CE multipliers and haircuts need to be completely transparent and based on historical analysis. The 2020 proposed rule retains the same CE multipliers as the 2018 proposal (Tables 15 – 19). In our 2018 comment letter, we explained that based on historic data, the CE Multipliers for guide-level and charter-level coverages should be 0.469 and 0.717 respectively, which is significantly lower than the CE Multipliers of 0.845 and 0.916, respectively, proposed in the 2018 rulemaking. This needs to be corrected. Please refer to Appendix C for details and a full analysis of this discrepancy. 2018 comment letter attached, for a detailed discussion on this point.

Additionally, the proposed rule includes a new 15 percent risk weight for residential mortgage loans which reduces the value of MI by approximately 5 percent—and this is after a counterparty haircut is already applied.

It is concerning that this proposal only provides credit from guide-level and chart-level mortgage insurance and does not contemplate deeper levels of MI. Should the Enterprises use deeper levels of MI, that reduction in risk should be recognized by the risk-based capital framework.

The 2020 NPR provides different levels of capital relief depending upon whether the mortgage insurance company is "approved" by the Enterprise to guarantee mortgage loans.[71] While we agree that it is an important distinction to be an approved versus non-approved entity, the reference is somewhat confusing in that it appears capital relief, albeit at a reduced level, will be afforded for mortgage insurance provided by a counterparty that is not approved by the Enterprise. This does not make sense.

[71] See proposed rule at §1240.33(a)("Approved insurer means an insurance company that is currently approved by an Enterprise to guarantee or insure single-family mortgage exposures acquired by the Enterprise.")

The only formally designated standard to be an "approved" insurance company is the Private Mortgage Insurers Eligibility Requirements (PMIERs). [72] This document includes not only minimum capital and other financial standards, but also operational and quality control requirements, conflict of interest restrictions, and mandated procedures. We do not believe that any company that is not in compliance with PMIERs should be an acceptable counterparty. And, consistent with the high standards contained in PMIERs, we believe than any company that satisfies PMIERs requirements should be considered an "Approved Insurer." Finally, as discussed below, in light of the high capital and credit standards and included in PMIERs, there is no justification for the imposition of a counterparty credit risk haircut for PMIERs compliant insures.

Question 46. ***Are there any adjustments, simplifications, or other refinements that FHFA should consider for the CE multipliers and the CP haircut multipliers for single-family mortgage exposures?***

See response to Question 45.

Question 47. Are the differences between the proposed rule and the U.S. banking framework with respect to the credit risk mitigation benefit assigned to loan-level credit enhancement appropriate? Which, if any, specific aspects should be aligned?

See response to Question 45.

Question 48. ***Is the minimum floor on the adjusted risk weight for a single- family mortgage exposure appropriately calibrated to mitigate model and related risks associated with the calibration of the underlying base risk weights and risk multipliers and to otherwise ensure each Enterprise operates in a safe and sound manner and is positioned to fulfill its statutory mission across the economic cycle?***

The minimum 15 percent floor for single-family mortgages should be removed.

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[72] PMIERs. "The Private Mortgage Insurer Eligibility Requirements (PMIERs) establish the requirements that a private mortgage insurance company must meet to be an approved insurer eligible to write mortgage guaranty insurance selected by a mortgage enterprise, for mortgages acquired by Freddie Mac pursuant to the Freddie Mac Single-Family Seller/Servicer Guide. This document is intended solely for the use of approved insurers and applicants for approved insurer status. For the avoidance of doubt, the PMIERs are not intended to have the effect of regulation, which is expressly the domain of regulators, but, rather, they set forth requirements an approved insurer must meet and maintain in order to provide mortgage guaranty insurance on mortgages acquired by Freddie Mac. This document contains requirements as well as guidelines associated with applying for, obtaining, and maintaining Freddie Mac approved insurer status, which status is determined in Freddie Mac's sole and absolute discretion. Approved insurers must meet requirements that are preceded by the term "must."" Page 3 PMIERs. https://sf.freddiemac.com/content/_assets/resources/pdf/requirements/pmiers.pdf

Although the Basel standardized approach requires a 50 percent risk weight for residential mortgages, it is inappropriate for the GSEs to use that as a benchmark considering the Enterprises are not banking institutions, and considering that the more accurate Basel advanced approach does not have a floor.

Further, the issues raised in the NPR justifying higher capital, including the 15 percent risk-weight floor on residential mortgages, are not "credit risks" but are actually political risk (the government will abandon the economy) or interest rate risk (that interest rates will not go lower during a financial panic) or natural disaster risk (the risk of earthquake, floods, or global warming) or legal risk (the foreclosure laws will change).

A better approach to ensuring this would be to establish a risk-based framework that incorporates an analytical and statistically-validated determination of unexpected losses. There could also be a contingency reserve to ensure the Enterprises are able to withstand a severe market downturn. Please refer to pages 18-19 for additional detail.

Question 49. ***Should the minimum floor on the adjusted risk weight for a single- family mortgage exposure be decreased or increased, perhaps to align the minimum floor with the more risk-sensitive standardized risk weights assigned to similar exposures under the Basel framework (e.g., 20 percent for a single-family residential mortgage loan with LTV at origination less than 50 percent)?***

The minimum 15 percent floor for single-family mortgages should be removed.

The proposed rule has 15 percent floor on the risk weight for residential mortgage loans, regardless of the risk weight that otherwise would be assigned based on loan characteristics and historic data. Thus, even if the models developed by FHFA indicate that the loan should only have a 5 percent risk weight, under the proposed rule the mortgage will nevertheless be assigned a 15 percent risk weight. This provision alone will increase required capital for each Enterprise by as much as 30 percent from the 2018 rule, which was itself also overly conservative.[73] Please refer to pages 18-19 for additional detail.

Question 50. ***Should the floor or other limit used to determine a single-family mortgage exposure's credit risk capital requirement be assessed against the base risk weight, the risk weight adjusted for the combined risk multipliers, or some other input used to determine that credit risk capital requirement?***

[73] Applying the 2018 framework to the Enterprises' September 30, 2019 book of business, the average risk weight on the Enterprises' single-family mortgage exposures would have been approximately 20%, while the average RWA under the proposed capital framework would be 26% (a 30% rise in capital requirements), with the increase primarily driven by the 15% risk weight.

The buffers should be based on risk-adjusted assets. The minimum 15 percent floor for single-family mortgages should be removed.

Question 65. ***What changes, if any, should FHFA consider to the operational criteria for CRT?***

It is important that capital relief for CRT transactions correspond to the actual credit risk transferred to private market participants. The combination of the leverage ratio and the lack of credit for CRT will encourage the Enterprises to take on more risk, and not distribute it. While the prior credit under the 2018 proposal for CRT might have been too generous, the CRT treatment in this proposed rule is not appropriate for an insurance type capital structure or entity.

For CRT, the 10 percent floor on CRT will make CRT uneconomical and should be removed. Recommendations to ensure CRT deals meet supervisory expectations without the implementation of punitive capital treatment: (1) establish and make public a transparent model to assess the capital benefit for CRT; and (2) establish and make public a specific set of disclosures and requirements for CRT structures. Please refer to pages 25-29 for additional detail.

Question 66. ***What changes, if any, should FHFA consider to the regulatory consequences of an Enterprise providing implicit support to a CRT?***

An Enterprise that provides implicit support to a CRT counterparty should be required to hold capital against the assets in which the risk was nominally transferred to the counterparty, and therefore should have to publicly disclose the action and reasons. Please refer to pages 25-29 for additional detail.

Question 67. ***Is the 10 percent prudential floor on the risk weight for a retained CRT exposure appropriately calibrated?***

The proposed rule excessively reduces the capital credit for CRT used by the Enterprises, and the 10 percent prudential floor is one of the biggest drivers of this reduction. By increasing the cost of transferring credit risk, the 10 percent prudential floor compels the Enterprises to retain more risk. The minimum leverage ratio in the proposed rule exacerbates the negative impact of the 10 percent prudential floor for CRT exposures, reducing the effective CRT benefit from $41.3 billion (as applied under the 2018 proposed rule) to $10 billion.

A slight adjustment for the general effectiveness of CRT is prudent to ensure that the Enterprises are not over-reliant on CRT and because a small amount of risk is retained when CRT is used, but it should not take the form of a capital floor. Therefore, the 10 percent prudential floor should be eliminated.

The effectiveness of CRT and its impact on the risk profile of the Enterprises should be the driving factors when determining associated capital requirements. To ensure that CRT transactions meet supervisory expectations without the implementation of punitive capital treatment, the FHFA should establish and make public: (1) a transparent model to assess the capital benefit for CRT; and (2) a specific set of disclosures and requirements for CRT structures. Please refer to pages 25-29 for additional detail.

Question 68. ***Should FHFA increase the prudential floor on the risk weight for a retained CRT exposure, for example so that it aligns with the 20 percent minimum risk weight under the U.S. banking framework?***

No, the Risk Weight floor already dramatically reduces the capital benefit of CRT and its use should not be further penalized as it relates to capital credit. For CRT, the 10 percent floor on CRT will make CRT uneconomical and should be removed.

Recommendations to ensure CRT deals meet supervisory expectations without the implementation of punitive capital treatment: (1) establish and make public a transparent model to assess the capital benefit for CRT; and (2) establish and make public a specific set of disclosures and requirements for CRT structures.

Question 69. ***Should FHFA take a different approach to an Enterprise's existing CRT?***

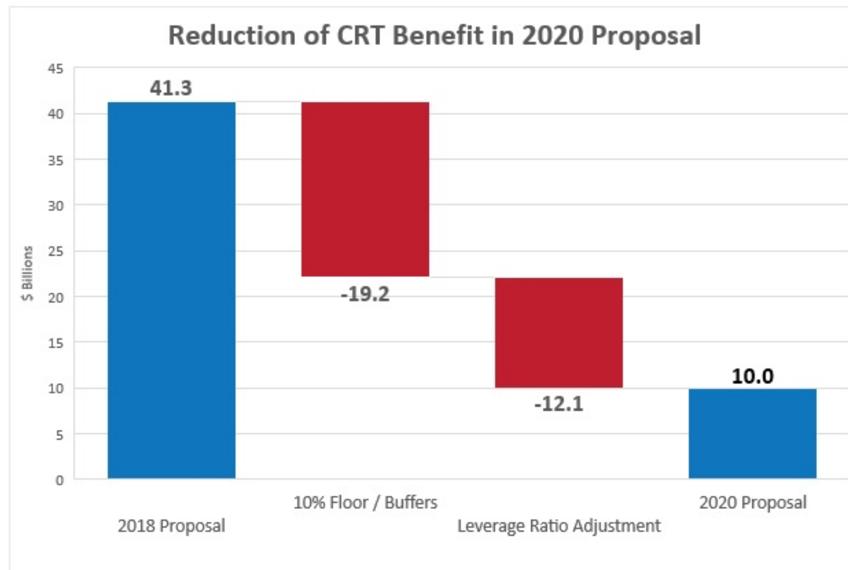
Overall, we recommend that the Enterprises receive capital credit without the introduction of the 10 percent minimum floor, and without the application of the leverage ratio, among other things (see please see responses to questions 65-68 for additional detail).

As stated in question 65, to ensure CRT deals meet supervisory expectations without the implementation of punitive capital treatment: (1) establish and make public a transparent model to assess the capital benefit for CRT; and (2) establish and make public a specific set of disclosures and requirements for CRT structures. These changes should be applied only to future CRT transactions.

However, if there are changes in this regard should only be for future CRT transactions. Please refer to pages 25-29 for additional details.

Question 70. ***Is the proposed approach to determining the credit risk capital requirement for retained CRT exposures appropriately formulated?***

No. The increased credit risk capital requirement for CRT is overly punitive and disincentivizes risk transfer by the Enterprises. The 2020 proposed rule ultimately reduces the capital credit for CRT by 46 percent from the 2018 proposed rule. The effectiveness of CRT and its impact on the risk profile of the GSEs should be the driving factors when determining the associated capital requirement.



Question 71. ***Are the adjustments for counterparty risk appropriately calibrated?***

We understand the need to ensure that GSEs are not over-reliant on CRT since those markets and investors will not always be available. The capital framework, however, should be calibrated in a manner that instills a preference for counterparties that will remain in the market through the cycle.

The proposed rule relies on a stress loss given default (LGD) of 45 percent which is not accurate in the case of MI counterparties, and it is unclear whether it's a proper LGD for reinsurance counterparties. FHFA should publish a more credible model of counterparty risk for reinsurers, including a table of objective criteria that determines risk grade assignments—that are equivalent from a capital perspective as PMIERs are for MIs. Please refer to pages 20-25 for additional details.

Question 73. ***Is the 10 percent adjustment for the general effectiveness of CRT appropriately calibrated?***

A slight adjustment for the general effectiveness of CRT is prudent to ensure that the Enterprises are not over-reliant on CRT and because a small amount of risk is retained when CRT is used. However, the proposed 10 percent adjustment is too high and will discourage the Enterprises from using CRT,

thereby raising their risk profile. The adjustment for CRT effectiveness should be determined based on the demonstrated reliability and benefits of CRT as well as the optimal ratio of retained risk to transferred risk on the balance sheets of the Enterprises. Please refer to pages 25-29 for additional details.

Question 74. ***Is* the *10 percent adjustment for the general effectiveness of CRT appropriate in light of the proposed rule's prudential floor on the risk weight for retained CRT exposures?***

As demonstrated in response to Questions 67 and 70, the elements of the proposed rule combine to significantly reduce the benefit to the GSEs of using CRT, and the 10 percent adjustment should be reduced in any case. The adjustment for CRT effectiveness should be determined based on the demonstrated reliability and benefits of CRT as well as the optimal ratio of retained risk to transferred risk on the balance sheets of the GSEs.

Question 100. ***Is the advanced measurement approach appropriately formulated and calibrated as a measure of operational risk capital for the Enterprises?***

The advanced measurement approach for operational risk relies on internal models and therefore is opaque. The models used and the predicted losses for operational events should be disclosed.

Question 101. ***Should FHFA consider other approaches to calculating operational risk capital requirements (e.g., the Basel standardized approach)?***

FHFA should consider designing a transparent framework for determining operational risk based on historic data and statistical analysis.

Question 102. ***Is the minimum floor on an Enterprise's operational risk capital appropriately calibrated?***

The calibration of the 15-basis point floor on operational risk is not disclosed, other than to say that it is approximately double the amount the Enterprises have calculated and approximately double the amount in the 2018 NPR. There is no information given in the NPR as to why doubling the amount is appropriate or how it was calibrated.

Question 103. ***Are the differences between the credit risk capital requirements for mortgage exposures under the proposed rule and the U.S. banking framework appropriate?***

The Basel standardized approach assigns a 50 percent risk weight for prudently underwritten first mortgage loans. This was done without any analysis of losses and is therefore an arbitrary number. The NPR attempts to refine the capital required through statistical data linked to key mortgage risk factors, and is therefore a better approach. Unfortunately, the NPR then adds buffers and floors to increase the capital charges so that the results no longer equate to actual risk.

Appendix B

See U.S. Mortgage Insurers' Testimony before the U.S. Senate Committee on Banking, Housing and Urban Development (Senate Banking Committee) here.

From the USMI's Senate Banking Committee testimony:

Utility Model. *Recent legislative proposals envision a role for the GSEs in a future housing system that supports an explicit government guaranty at the security level, call for the GSEs to ensure access for smaller lenders, and include affordable housing requirements. These proposals signify that Congress feels there are critical functions at the GSEs and deem these functions/features necessary in a future housing finance system—either within the GSEs or placed in a separate utility of public exchange. Further, Congress benefits from the multitude of proposals from both progressive and conservative organizations on housing finance reform. These proposals—including from industry trades, consumer organizations, and think tanks—have one critical similarity among them—the vast majority of perspectives on both comprehensive legislative and/or Administrative reform is the recognition that policymakers must reduce the GSEs' duopolistic market dominance to create long-term safety and soundness in the housing finance system. And, while different reform proposals may call it different things and rely specifically on different infrastructures to achieve it,* ***many of the leading legislative and Administrative proposals for GSE reform have leaned on some utility-like secondary mortgage market function to reduce the GSEs' current duopoly and market power in the mortgage finance system. Nearly all proposals call for Fannie Mae and Freddie Mac to have capped rates of return, be limited in their scope of activities, and be more open and transparent to the private market, policymakers, and consumers.*** *Perhaps a simpler approach—and as a means to help transition to a comprehensively reformed system—is rather than creating an entire new utility to transfer the critical systems and functions of the GSEs to immediately, the GSEs themselves could be turned into highly regulated utility-like entities, with transparent capital and pricing, explicit and limited functions in the secondary market, and open-access and transparent underwriting engines and systems. These steps could be taken by incremental legislation or by Administrative actions.*

USMI continues to believe that until Congress enacts comprehensive legislative reform to the GSEs, they should be regulated as utility-like entities. Doing so would:

- **Maintain the Enterprises as Market Makers.** The Enterprises could have an explicit guaranty of their mortgage-backed securities (MBS)—including the more recent uniform mortgage backed security (UMBS), enabling the Enterprises to continue to facilitate the 30-year fixed-rate mortgage and maintain their ability to be market makers

- **Provide stability through different market cycles.** As evidenced by the current COVID-19 crisis, the Enterprises have a pivotal role in providing stability through different housing cycles. Through COVID-19, because of their utility-like regulation under conservatorship, the GSEs were able to quickly provide standardized relief and forbearance options to borrowers with GSE-backed mortgages. This is in direct contrast with borrowers who have loans backed by private labeled securities where there has been less uniformity in borrower relief and treatment.
- **Protect Taxpayers:** Utility-like regulation also greatly diminishes the need of the Enterprises to compete with other sectors of the market—which has traditionally led them to either enter into markets currently served well by the primary market on an unlevel playing field, or compete in an unhealthy manner with the private sector in the primary market, which at times, can lead to a "race to the bottom" affect for mortgage quality. Further, while there is a potential for profit for holding credit risk, utility-like regulation that sets an appropriate return model for the Enterprises, should also encourage the distribution of mortgage credit where possible to protect taxpayers. This includes transferring first-loss risk to entity-based private credit enhancement, such as MI, and transferring mezzanine layers of credit risk through credit risk transfer (CRT) such as reinsurance and capital markets to further diversify their risk and to ensure greater taxpayer protection.
- **Ensure accessibility to sustainable, affordable mortgage finance credit.** Utility-like regulation enables the regulator to maintain adequate oversight of the Enterprises such that they do not need to compete the same way that other private companies compete, but instead are able to provide their intended role in the marketplace. This allows FHFA to establish a capital regime that is appropriate to protect taxpayers yet maintains the Enterprises' ability to provide sustainable access to mortgage finance credit to all geographic regions. This also would better align a capital regime, not to be based on what investors demand for returns for big banks, but instead on the mortgage credit risk that the Enterprises assume.

Appendix C

Treatment of Counterparties

Results: The results from both the historical and forward-looking analysis suggest that the proposed CE Multipliers are too large.[74]

Capital Rule Should Recognize the Value of MI Protection

To measure the effectiveness of different credit enhancement, the NPR uses CE Multipliers, which are supposed to reflect the effectiveness of MI in protecting loan owners from unexpected losses. We define "MI Effectiveness" and use it below via the formula:

CE Effectiveness = 1 – CE Multiplier

To assess the accuracy of the proposed CE multipliers under the NPR, USMI did both a historical analysis as well as a forward-looking analysis using Enterprise data, provided below.

Several factors will influence MI Effectiveness. The first is the ratio of loss-given-default (LGD) to the MI coverage ratio. For example,

– Assuming:

- The total liquidating expense and interest cost is 15 percent of defaulted unpaid principal balance (UPB)
- The LGD of a loan is 50 percent
- Coverage ratio is 30 percent

– With those considerations, The MI Effectiveness will be:

(1+15 percent) * 30 percent / 50 percent = 69 percent

– The corresponding CE Multiplier is 0.31 (note this is consistent with the proposed CE Multiplier for loans with Non-Cancellable MI in both the 2018 and 2020 proposed rules)
– Thus, the higher the LGD, the lower the MI Effectiveness

[74] USMI's analytical results and baseline assumptions for analysis are included in these Appendices. USMI is pleased to share the additional methodology upon request.

Another important factor is the MI cancellation feature. Due to the Homeowners Protection Act, borrower-paid MI policies automatically terminate when the scheduled LTV ratio reaches 78 percent provided that the loan is performing.

There are two key drivers of CE Multipliers:

– The LGD
– The likelihood that the MI policy will be canceled before a default.

Based on our research and as highlighted below, CE Multipliers are overstated, especially for high LTV and seasoned loans.

Historical Analysis

To test the MI effectiveness under the 2008 crisis, we did an empirical analysis, using all Enterprise loans from the Single-Family Mortgage Databases of Fannie Mae and Freddie Mac that match loan attributes of two selected cells from Table 16 (p.138 of the 2020 NPR):[75]

– 30 years fixed rate mortgage with 90<LTV=95
– 72 < loan age by month <= 84 at 2007Q1
– Performing and scheduled LTV above 78 at 2007Q1
– Not modified
– Two coverage assumptions: 30 percent and 16 percent

We also assumed that the LGD of those loans are 50 percent, and the combination of liquidating expense and interest costs are 10 percent and 20 percent of defaulted UPB for Foreclosure Alternative and REO respectively.

[75] 85 FR 39274, p.138.

NPR Table 16: CE Multipliers for Performing Loans and Non-Modified RPLs Subject to Cancellable MI

			Loan Age											
	OLTV	Coverage Percent	<= 5	>5, <= 12	>12, <= 24	>24, <= 36	>36, <= 48	>48, <= 60	> 60, <= 72	> 72, <= 84	> 84, <= 96	>96, <=108	>108, <=120	>120
15/20 Year	>80%, <=85%	6%	0.997	0.998	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
Amortizing	>85%, <=90%	12%	0.963	0.971	0.988	0.999	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
Loan with	>90%, <=95%	25%	0.826	0.853	0.912	0.973	0.996	1.000	1.000	1.000	1.000	1.000	1.000	1.000
Guide-level	>95%, <=97%	35%	0.732	0.765	0.848	0.936	0.986	0.998	1.000	1.000	1.000	1.000	1.000	1.000
Coverage	>97%	35%	0.630	0.673	0.762	0.865	0.945	0.980	0.996	1.000	1.000	1.000	1.000	1.000
30 Year	>80%, <=85%	12%	0.867	0.884	0.928	0.962	0.994	0.999	1.000	1.000	1.000	1.000	1.000	1.000
Amortizing	>85%, <=90%	25%	0.551	0.584	0.627	0.679	0.785	0.893	0.950	0.986	0.998	1.000	1.000	1.000
Loan with	>90%, <=95%	30%	0.412	0.440	0.456	0.484	0.547	0.654	0.743	0.845	0.932	0.969	0.992	1.000
Guide-level	>95%, <=97%	35%	0.322	0.351	0.369	0.391	0.449	0.535	0.631	0.746	0.873	0.925	0.965	1.000
Coverage	>97%	35%	0.272	0.295	0.314	0.353	0.410	0.462	0.515	0.607	0.756	0.826	0.887	1.000
15/20 Year	>80%, <=85%	6%	0.997	0.998	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
Amortizing	>85%, <=90%	12%	0.963	0.971	0.988	0.999	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
Loan with	>90%, <=95%	16%	0.887	0.904	0.943	0.983	0.997	1.000	1.000	1.000	1.000	1.000	1.000	1.000
Charter-level	>95%, <=97%	18%	0.854	0.874	0.918	0.966	0.992	0.999	1.000	1.000	1.000	1.000	1.000	1.000
Coverage	>97%	20%	0.788	0.810	0.859	0.922	0.969	0.989	0.998	1.000	1.000	1.000	1.000	1.000
30 Year	>80%, <=85%	6%	0.934	0.943	0.964	0.981	0.997	0.999	1.000	1.000	1.000	1.000	1.000	1.000
Amortizing	>85%, <=90%	12%	0.780	0.795	0.819	0.845	0.896	0.948	0.976	0.993	0.999	1.000	1.000	1.000
Loan with	>90%, <=95%	16%	0.679	0.690	0.703	0.719	0.755	0.813	0.861	0.916	0.963	0.983	0.995	1.000
Charter-level	>95%, <=97%	18%	0.642	0.652	0.662	0.676	0.708	0.756	0.806	0.866	0.933	0.960	0.981	1.000
Coverage	>97%	20%	0.597	0.607	0.617	0.629	0.658	0.686	0.715	0.765	0.845	0.882	0.914	1.000

Historical Analysis—The Results

The result of our test, based on our LGD assumptions, is that **the correspondent CE Multipliers for guide-level and charter-level coverages should be 0.469 and 0.717 respectively, which are significantly lower than the CE Multipliers of 0.845 and 0.916, respectively, proposed by the NPR for this group of loans.**

Looking at the performance of MI through the last financial crisis, others have also reached a similar conclusion that the CE Multipliers are overstated. One report from Urban Institute[76] shared similar viewpoints. According to the report, which was based on historical performance of the industry through the financial crisis, the mortgage insurance "haircut" is quite conservative. The report found that:

- For "cancelable" MI with 30 percent coverage (guide-level coverage) from a "3 rated non-diversified" MI, for defaults occurring in year 6, the capital is reduced by only 14 percent.
- (1-0.845) * (1-0.083) = 14.2 percent

[76] Ed Golding and Jun Zhu, FHFA Capital Proposal: Preliminary Thoughts, Sunset Seminar: GSE Pricing and Cross-Subsidization(Urban Institute, July 2018).

- Using a 50 percent LGD (severity), the implied effectiveness of MI is approximately 50 percent for 90 LTV mortgages and 70 percent for 95 LTV mortgages.
- In practice (and the data), with guide level coverage, MIs cover well over half the losses even in times of stress.

Forward Looking Analysis

Further, using a forward-looking analysis which uses a stressed scenario worse than the financial crisis of 2008, **we found the CE Multipliers should be much lower than those proposed in the NPR.**

This analysis was conducted using recently originated (2017Q3) loans and customized a scenario meant to mimic the approach described in the FHFA proposal. To align with the two cells in Table 16, we selected loans with the same attributes as was done in the historical analysis.

The data was extracted from the Enterprises' websites in May 2018 and was prepared using two scenarios starting from 2017Q3. This analysis allows an assessment of the CE Multipliers applicable to an unexpected loss by using the difference between these two scenarios (i.e. using the Baseline scenario as an expected case). The modified Stress scenario follows a national HPA path consistent with the assumption of the FHFA method.

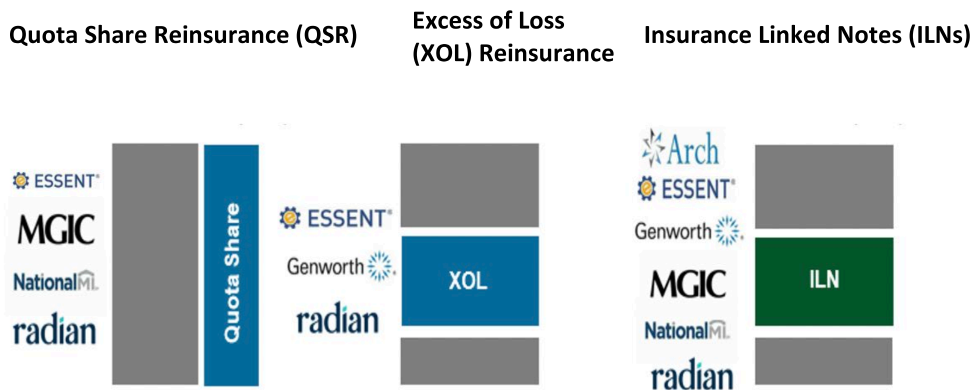
Forward Looking Analysis—The Results

For the projections with Guide-level coverage, 34.48 percent of unexpected loss is covered by MI. The corresponding CE multiplier should therefore be 0.655, which is much lower than the 0.845 proposed by the NPR. For the projections with Guide-level coverage, 18.64 percent of unexpected loss is covered by MI. The implied CE multiplier should be 0.814, which is much lower than the 0.916 multiplier proposed by the NPR. **The results suggest that the proposed CE Multipliers are too large.**

Appendix D

MI Credit Risk Transfer ("MI CRT") Structures

Below is an overview of how these structures operate to meaningfully transfer MI risk to other sources of private capital around the globe.



Reinsurance: Quota Share ("QSR") and Excess of Loss ("XOL")

- *QSRs* are essentially vertical strips of risk that are reinsured by 3rd party insurance companies. The reinsurers will incur losses pro-rata with the mortgage insurer on the total coverage in return for a share of the premium.
- In *XOL* transactions, the reinsurer assumes a horizontal slice of the risk—a mezzanine layer, similar to how ILNs work.

Capital Markets: Insurance Linked Notes ("ILNs")

- *ILNs* are bonds issued by a special purpose insurer (SPI) tied to the performance of a reference pool of mortgage insurance policies. Bonds are sold to fully collateralize the SPI's reinsurance obligation for a certain level of risk coverage on the reference pool for the ceding mortgage insurer. The proceeds are placed into an onshore trust and invested in Treasury Money Market Funds for the benefit of covering future "unexpected" losses of the reference pool.
- The notes typically begin to incur losses after the first ~2.25-2.50 percent of claims are paid on reference pool with the first "tranche" of risk being borne by the ceding mortgage

insurer. The notes receive LIBOR + a spread depending on their respective risk coverage from the ceding mortgage insurer with the interest expense partly offset by the investment income generated from Treasury Money Market Funds in the trust.

There has been widespread recognition among state regulators of the significant benefit that insurance companies achieve by diversifying and distributing risk through these CRT techniques. Insurance regulators also understand that it is important to have stringent transaction requirements to ensure that real risk is effectively transferred. Among other things, an MI company must disclose to their regulators the identities of CRT counterparties and a pro forma financial statement showing the effect of the CRT transaction on the MI company in both an expected and stress scenario. The Enterprises, through the PMIERs mandate, also set stringent requirement to ensure that CRT transactions conducted by approved MI companies meaningfully transfer risk.[77]

[77] Section 707 of PMIERs specifically sets forth very detailed and specific requirements for MI CRT transactions for the MI receiving a capital benefit from these transactions, which include among many other things the loan level data file of covered loans, the name of the reinsurer panel (if an XOL or QS transaction) and many other requirements for ILN structures. Further, private MIs must also attain a risk transfer opinion/analysis in order to receive the reinsurance treatment.

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Appendix E

Page 233, Table 2a	Fannie Mae	
	2018 Proposal 9/30/2019	2020 Proposal 9/30/2019
Total Adjusted Assets	$3,547.4	$3,547.4
Net Credit Risk	$65.4	$80.3
CRT Impact	(19.8)	(10.5)
Post CRT Credit Risk	45.6	69.8
Risks, Buffers, DTA	40.2	75.3
Total Capital Requirement	$85.8	$145.1
Leverage Ratio	2.42%	4.09%
Additional Capital for Minimum Leverage Ratio		0.0
Total Capital Requirement + Leverage		$145.1
Leverage Ratio		4.09%

Page 234, Table 2b	Freddie Mac	
	2018 Proposal 9/30/2019	2020 Proposal 9/30/2019
Total Adjusted Assets	$2,524.6	$2,524.6
Net Credit Risk	$43.7	$54.6
CRT Impact	(21.5)	(11.6)
Post CRT Credit Risk	22.2	43.0
Risks, Buffers, DTA	28.9	45.9
Total Capital Requirement	$51.1	$88.9
Leverage Ratio	2.02%	3.52%
Additional Capital for Minimum Leverage Ratio		12.1
Total Capital Requirement + Leverage		$101.0
Leverage Ratio		4.00%

Combined Tables	GSEs	
	2018 Proposal 9/30/2019	2020 Proposal 9/30/2019
Total Adjusted Assets	$6,072.0	$6,072.0
Net Credit Risk	$109.1	$134.9
CRT Impact	(41.3)	(22.1)
Post CRT Credit Risk	67.8	112.8
Risks, Buffers, DTA	69.1	121.2
Total Capital Requirement	$136.9	$234.0
Leverage Ratio	2.25%	3.85%
Additional Capital for Minimum Leverage Ratio		12.1
Total Capital Requirement + Leverage		$246.1
Leverage Ratio		4.05%

CRT Benefit Walk	Fannie Mae	Freddie Mac	GSEs
CRT Benefit in 2018 Proposal	**$19.8**	**$21.5**	**$41.3**
Change in CRT driven by 10% floor and buffers	($9.3)	($9.9)	($19.2)
CRT Benefit in 2020 Proposal	**$10.5**	**$11.6**	**$22.1**
Offset to CRT to maintain the Minimum Leverage Ratio	0.0	(12.1)	(12.1)
"Effective" CRT Benefit	**$10.5**	**($0.5)**	**$10.0**

CRT Utilization	Fannie Mae Utilization % of Credit Risk	Fannie Mae Utilization Walk	Freddie Mac Utilization % of Credit Risk	Freddie Mac Utilization Walk	GSEs Utilization % of Credit Risk	GSEs Utilization Walk
2018 Proposal	**30%**	**30%**	**49%**	**49%**	**38%**	**38%**
After increases in Net Risk	25%	-6%	39%	-10%	31%	-7%
After 10% floor and buffers	13%	-12%	21%	-18%	16%	-14%
After Leverage Ratio Adjustment	13%	0%	-1%	-22%	7%	-9%
2020 Proposal	**13%**	**13%**	**-1%**	**-1%**	**7%**	**7%**