Center for Responsible Lending

Comment to the Federal Housing Finance Agency on Resolution Planning Notice of Proposed Rulemaking

12 CFR Part 1282, RIN 2590-AB13

March 9, 2021

Submitted via FHFA website

The Center for Responsible Lending (CRL)[1] appreciates the opportunity to comment on the Federal Housing Finance Agency's (FHFA) Resolution Planning proposed rule. FHFA seeks comment on a proposal that would require Fannie Mae and Freddie Mac (GSEs) to develop plans to facilitate their rapid and orderly resolution in the event FHFA is appointed receiver pursuant to 12 U.S.C. 4617. Such a resolution plan, also known as a living will, is to ensure that there is a contingency plan for how a large financial institution will sell off assets or be liquidated without causing turmoil elsewhere in the financial system.

Currently, only the largest banks are required to have a resolution plan. This makes sense, as banks of such enormous size typically have hundreds of operating subsidiaries, including in countries outside the United States. A large bank failure could have major ripple effects throughout the national and global economy. It is critical to have a methodical method to wind down such complex institutions.

Yet, such a framework is illogical for a GSE. The GSEs are distinct from banks in several material ways: 1) GSEs are simpler entities with lower risks, 2) the GSEs receive government support through the Preferred Stock Purchase Agreements (PSPAs), and 3) the GSEs are chartered to fulfill a significant and specific mission, which makes receivership a far less desirable policy outcome. Moreover, a living will is likely to add unnecessary uncertainty and cost to the overall mortgage market.

I. The Proposed Rule Erroneously Applies to the GSEs a Living Will Framework for Large Banks

A. The Proposed Rule Overestimates the GSEs' Risks

The GSEs are monoline entities which hold less risk on mortgage loans than banks do. First, the GSEs' credit losses on mortgage loans are considerably lower than bank losses. The GSEs experience fewer losses at least partly because they are better insulated from adverse scenarios given their superior diversification of risk by geography and lender. For example, GSE single-family mortgage credit losses from 2007 forward were half that of depositories.[2] According to another analysis looking at a longer time period (1992 through 2019, 28 years of data), Fannie Mae single-family credit loss rates were just 40% that of banks – 15 basis points compared with bank losses of 37.[3]

Second, and more importantly, banks take on funding/liquidity, interest rate, and prepayment risks on their mortgages, while the GSEs sell off all those risks to MBS investors. Virtually all GSE mortgages are placed in MBS that are purchased by outside investors, leaving the GSEs with none of these risks to

[1] CRL is a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, one of the nation's largest nonprofit community development financial institutions. For 40 years, Self-Help has created asset-building opportunities for low-income individuals, rural communities, women, and families of color. In total, Self-Help has provided over $9 billion in financing to 172,000 homebuyers, small businesses, and nonprofit organizations and serves more than 160,000 mostly low-income families through 72 credit union branches in North Carolina, California, Florida, Illinois, South Carolina, Virginia, Washington, and Wisconsin.

[2] Jim Parrott, Bob Ryan and Mark Zandi, *FHFA's Capital Rule is a Step Backward*, at p. 6, Table 4 (July 2020), https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward_0.pdf.

[3] Enterprise Regulatory Capital Framework, Comment Letter to FHFA from Tim Howard (2020), https://www.fhfa.gov//SupervisionRegulation/Rules/Pages/Comment-Detail.aspx?CommentId=15548.

manage. By contrast, banks fund the long-term mortgages they hold with short-term deposits or debt, making the banks subject to runs on deposits or disruptions in the funding markets, and to excess prepayments if rates fall or negative interest rate spreads if rates rise, similar to what the savings and loan industry faced. These risks are significant, exceeding mortgage credit risks in potential severity over time.[4] While FHFA states that bank funding and interest rate risks are handled through supervision, that is not the same as transferring those risks entirely, as the GSEs do.

Further distinguishing the GSEs from banks, the PSPAs and FHFA have required the GSEs to dramatically reduce the size of their retained portfolios, which now are below $400 billion combined and largely serve to support their credit guarantee business.[5]

B. The Proposed Rule Ignores the Fact that GSEs Receive Government Support Through the PSPAs

The proposed rule appears to deny the existence of the PSPAs by treating the PSPAs as unavailable to the GSEs in a time of stress. However, this effectively ignores the support provided by the government – the most efficient provider of catastrophic coverage – through the PSPAs, which the GSEs will pay for through a periodic commitment fee. Furthermore, the proposed rule requires a GSE to continue operations in receivership without any government support. This is impractical, as that support is required for the GSE business model even when not in distress and facing receivership.

Congress approved establishment of the PSPAs in 2008 under which Treasury commits to fund any net worth shortfalls in the GSEs up to a certain amount. The PSPAs provide an explicit functional government guarantee of both GSE MBS and non-MBS liabilities, which ensures global demand for the GSEs' mortgage-backed securities, keeping mortgage rates low and the 30-year fixed-rate, prepayable mortgage widely available, and ensures continued solvency of the GSEs themselves. The PSPAs' support to the GSEs is effective because they are legally irrevocable for the benefit of GSE MBS and debt holders with no expiration date. The PSPAs create binding obligations on the government so long as there are undrawn commitment amounts and MBS or debt holders to protect. If Treasury or FHFA reneged on its commitment to fund net worth deficits in the GSEs up to the remaining PSPA commitment amounts, GSE debt and MBS holders have an explicit private right of action against the government for liquidated damages to force the commitment to be met.[6]

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[4] *See* Edward Golding, Laurie Goodman and Jun Zhu, *Analysis of the Proposed 2020 FHFA Rule on Enterprise Capital*, Urban Institute (August 2020), at pp. 6-7, https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital_0.pdf.

[5] If a loan in an MBS subsequently defaults, the GSE will purchase the loan out of the pool, making the investor whole, and place the loan on its retained portfolio funded by unsecured debt. The GSE will attempt to modify the loan. Over time, the GSEs reduce their retained portfolios through re-securitizations or sales of non-performing and re-performing loans, or through completed foreclosures, as they have effectively done since the crisis. Under the 2018 and 2020 proposed rules, the risk-based capital requirements appropriately take into account the market risks of the retained portfolio.

[6] *See* Amended and Restated PSPA (September 26, 2008), Section 6.1, pp. 8-9, https://www.fhfa.gov/Conservatorship/Documents/Senior-Preferred-Stock-Agree/FNM/SPSPA-amends/FNM-Amend-and-Restated-SPSPA_09-26-2008.pdf.

The government's PSPA commitment continues whether the GSEs are in or out of conservatorship. While the PSPA support is limited, once the GSEs are capitalized to remain going concerns through another 2008 crisis, the PSPA commitment of $254 billion is large enough to cover yet another 2008-type event, providing MBS investors strong confidence that the GSEs will be able to continue guaranteeing MBS. In fact, the GSEs have been able to maintain their market presence and play a critical countercyclical role due to PSPA support even before they built up capital. The PSPAs were effective coming through the Great Recession when the GSEs were suffering operating losses and in 2018 when the GSEs had no capital at all. It thus makes little sense to ignore this support in assessing the suitability of a resolution plan.

Banks do not have equivalent government support. While banks have access to the discount window from the Federal Reserve and their deposit liabilities are guaranteed by Federal Deposit Insurance Corporation insurance, they do not have access to automatic infusions of net worth from the government in a crisis. A large bank can fail and no longer remain a going concern, thus making a resolution plan critical to minimize financial chaos in the system.[7]

C. The GSEs Are Chartered to Fulfill a Significant and Specific Mission

While banks have a Community Reinvestment Act obligation to serve the needs of the communities in which they are located, including the need for various forms of credit, the nature and reach of the GSEs' public mission is much more central to the fundamental operations of the GSEs than to those of banks. In exchange for government support, the GSEs have an explicit public interest mission. This mission is foundational and part of their charters – the GSEs' very reason for existing.[8]

First, the GSEs were created to promote access to credit throughout the Nation, with an emphasis on housing for low- and moderate-income families and underserved areas, including "minority census tracts."[9] The GSEs are required to meet affordable housing goals and have a duty to serve underserved markets.[10] As part of their mission, the GSEs are to pursue "activities relating to mortgages on housing

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[7] For a discussion of the failures of IndyMac and Washington Mutual, *see* David Min, *How Government Guarantees in Housing Finance Promote Stability*, 50 Harv. J. Legis. 437 (2013), at p. 478, n. 227, https://scholarship.law.uci.edu/cgi/viewcontent.cgi?article=1036&context=faculty_scholarship.

[8] *See* 12 U.S.C. § 1716; 12 U.S.C. § 1451. The legislated purpose of the GSEs, as stated in their charters, is to:

1. provide stability in the secondary market for residential mortgages;
2. respond appropriately to the private capital market;
3. provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;
4. promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;
5. manage and liquidate federally owned mortgage portfolios in an orderly manner, with a minimum of adverse effect upon the residential mortgage market and minimum loss to the Federal Government.

[9] 12 U.S.C. § 4564.

[10] 12 U.S.C. § 4561; 12 U.S.C. § 4565.

for low- and moderate-income families involving a reasonable economic return *that may be less than the return earned on other activities* . . . ." (emphasis added).[11] The GSEs do so pursuing lower required but positive returns for certain purchase and rate-term refinance borrowers, particularly those who are lower-income or lower-wealth. Indeed, as quasi-insurance companies, a crucial function of the GSEs is to pool risk nationally. Pooling risk is key to the GSEs' ability to serve underserved borrowers and meet their charter mission.

Second, the GSEs have an explicit countercyclical mission, while banks are expected to retrench when economic conditions weaken. This is reflected in the GSEs' requirements to "provide stability in the secondary market for residential mortgages", "respond appropriately to the private capital market", meaning fill in for it when it retreats, and "provide *ongoing* assistance to the secondary market for residential mortgages" (emphasis added).[12] Unlike other participants in the housing finance system, the GSEs are needed to continue providing mortgage liquidity in a crisis or the entire housing finance system will seize up, harming the national economy. For example, during and after the 2008 financial crisis, private-label securities (PLS) funding evaporated; the GSEs, along with Ginnie Mae, picked up the slack.[13] Moreover, the GSEs are playing a critical role during the COVID-19 crisis. As the Urban Institute found, during the first six months of 2020, the GSEs added $214 billion in net issuance, while the non-agency market dramatically pulled back because of COVID-19 liquidity concerns.[14]

Lastly, while both the GSEs and banks must operate in a safe and sound manner, only the GSEs carry significant congressionally-chartered responsibility for the housing finance system as a whole.

II. The Proposed Rule Would Create Disruption, Uncertainty, and Costs

While the proposed rule states that the living will "[m]inimizes disruption in the national housing finance markets by providing for the continued operation of the core business lines of an Enterprise in receivership by a newly constituted limited-life regulated entity," the LLRE would in fact create more disruption. If there is no government support, there can be no new loan purchases by the GSEs. If a GSE were to fail and be placed into an LLRE, it would create enormous stress in the second-largest global debt market. It is also highly likely that the market would assume the LLRE acts as a vehicle to liquidate assets, only aggravating the stress.

Given the GSEs' fundamental and critical role in the housing market, placing these entities into receivership is an undesirable policy outcome and would have disastrous ramifications on access to mortgage liquidity that today is mostly benefitting wealthier borrowers. Rather, as occurred in 2008, the government placed the GSEs into conservatorship, minimizing market distress and helping to preserve the flow of mortgage credit.

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[11] 12 U.S.C. §§ 1716(4) and (3).
[12] *See* 12 U.S.C. § 1716; 12 U.S.C. § 1451.
[13] David Min, *How Government Guarantees in Housing Finance Promote Stability*, 50 Harv. J. Legis. 437 (2013), at p. 467, https://scholarship.law.uci.edu/cgi/viewcontent.cgi?article=1036&context=faculty_scholarship.
[14] Edward Golding, Laurie Goodman and Jun Zhu, *Analysis of the Proposed 2020 FHFA Rule on Enterprise Capital*, Urban Institute (August 2020), at p. 9, https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital_0.pdf.

Moreover, even in normal times a living will is harmful and creates unnecessary uncertainty in the mortgage market. The proposed rule would require the GSEs to show how, without government support, they would continue to perform their "core or important business lines" in receivership – an impossible requirement for the GSEs to meet. The GSEs' business model requires government support that investors view as strong enough so that MBS investors have virtually no credit risk, solely interest rate risk. Because investors and lenders have believed the government stood behind the GSEs, investors have been willing to buy GSE liabilities at near-Treasury rates. Indeed, the hallmark of the GSEs' support of the primary mortgage market has been that investors and lenders pursue their business models around the continued operation of the GSEs. If investors ever believe that the government is not fully behind the GSEs, as the living will would suggest through the denial of the PSPAs, this business model disintegrates. This could engender a crisis of market confidence and suggest investors should hedge the existing model, creating unnecessary uncertainty and cost in the system.

Instead, FHFA must prioritize strengthening the GSEs' affordable housing goals as outlined in our comment submitted on February 28, 2021.[15] The GSEs have woefully unfulfilled their statutory obligations to ensure adequate activity to Black, Latino, and other communities of color since the Great Recession. Therefore, FHFA must take swift and bold action now in creating affordable housing goals that can help return the GSEs to former periods when their activity was much stronger. A key goal of the affordable housing goals must be to help to build toward more racial equity in homeownership. The GSEs should focus explicitly on addressing racial homeownership gaps; marginal improvements are insufficient given the GSEs' charters that cite the GSEs' responsibility to underserved communities and borrowers of color, including to "minority census tracts."

Conclusion

A living will requirement in the same vein as the large banks is simply inappropriate for the GSEs. Living wills are highly technical and complex documents. As FHFA indicates in the proposed rule, it would be a significant undertaking for the GSEs to produce such a document. Banks engage in more activities, take more types of risk, and are operationally more complex. By contrast, the GSEs are monoline, relatively simple businesses and should use a more straightforward framework that takes the existing government support into account. Therefore, this exercise is not one that FHFA should be engaging in, or if it does, that it should place a priority on.

[15] Comment from CRL to FHFA on Enterprise Affordable Housing Goals Advance Notice of Proposed Rulemaking (Feb. 28, 2021), https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-comment-fhfa-affordable-housing-goals-anpr-feb2021.pdf.