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FEDERAL HOUSING FINANCE AGENCY
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Amendments to the Enterprise Regulatory Capital Framework Rule

FHFA recently proposed amending the GSE capital rule in two ways: (a) lowering the prescribed leverage capital buffer amount (PLBA), and (b) increasing the capital savings from transferring risk through CRT by reducing the risk retention floor. Theory and empirical evidence suggest these amendments improve incentives for prudent GSE risk and capital management. We have written extensively on the 2018 FHFA Enterprise Capital Rule proposal and the 2020 rule, and provide comments here on the proposed amendments.

About Andrew Davidson & Co.

Andrew Davidson & Co., Inc. (AD&Co) is pleased to provide our comments in response to FHFA's NPR to amend the Enterprise Capital Regulatory Framework. For nearly thirty years, AD&Co has provided analytical tools to the mortgage finance industry. These tools include models of mortgage loan dynamics including prepayments, delinquencies, and losses, as well as valuation models that assess cash flows, value, and risk of mortgages; mortgage-backed securities; and mortgage securities servicing. The company's clients represent a broad cross section of the mortgage finance community, including originators, servicers, guarantors, investors, and regulators.

Directional Impact

Lowering the PLBA doesn't lower overall capital so much as making risk-based capital more relevant. Reducing the risk-weight floor on retained CRT risk raises the regulatory value of risk-transfer closer to its economic value, re-encouraging the GSEs to transfer credit risk from taxpayers to the private capital market.

Our view of these changes is guided by two fundamental views. First, in a capitalist system, even imperfect markets that benefit from a federal backstop function better when private capital and market prices are encouraged. Thus, encouraging credit risk transfer through closer alignment between regulatory and economic capital is productive. Second, capital should generally relate to risk. Therefore, it's preferable that risk-based metrics hold more frequently than non-risk-based capital floors. Further, FHFA CCAR results run twice in the past few years, along with our own results, suggest pure risk-based capital of less than 1%. A significant capital buffer is certainly appropriate, but the 2020 rule is quite likely excessive to the point of impairing the GSEs' ability to meet their mission. Therefore, refining the capital rule so that risk-based capital is more frequently the binding constraint, and that risk transfer is favored, is clear progress.

Finally, a distortion remains between the regulatory and economic value of CRT because credit risk is still apportioned across the entire retained notional balance of mortgages rather than focused on the most junior portion of the retained exposures. Focusing on the retained classes up to approximately double the required capital for that exposure would increase the regulatory incentive for deeper risk transfer.