AEI Housing Center

American Enterprise Institute
1789 Massachusetts Ave. NW
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Enterprise Regulatory Capital Framework

Federal Housing Finance Agency

Proposed: September 15, 2021

Comment Period Closes: November 26, 2021

Submitted: November 10, 2021

Docket No. 2021-20297

RIN: 2590-AB17

Re.: FHFA's Proposed Amendments to its Enterprise Regulatory Capital Framework

Dear Sir/Madam:

Thank you for the opportunity to comment on FHFA's Proposed Amendments to its Enterprise Regulatory Capital Framework.

It would be a pleasure to discuss this recommendation further with you at your convenience, should you so desire. Thank you again for the chance to participate in this timely rulemaking.

Yours respectfully,

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Comment on FHFA's Proposed Amendments to its Enterprise Regulatory Capital Framework

FHFA's proposal of September 15, 2021 would significantly alter its Enterprise Regulatory Capital Framework of the giant housing-related government-sponsored enterprises (GSEs)—Fannie Mae and Freddie Mac less than seven months after that rule's initial effective date. The proposed solution, though, would be an unfortunate choice that would undermine the FHFA's mission by substantially weakening the capital standards critical to GSEs' safety and soundness, should they someday be released from their conservatorships. While the proposal would meaningfully address a concern that the current framework might fail to optimally incent risk reduction activities of the GSEs, there are far better ways to ensure that the GSEs transfer most of their credit risk to the private sector.

The GSEs' Capital Standards Are Too Weak Already

Policymakers have responded to the GSE collapse of 2008, not by restructuring our housing finance system to rely much less, if at all, on Fannie Mae and Freddie Mac, but instead by letting them increase their domination over private institutions.[1] Their failure in a housing market crisis would, therefore, be even more disastrous than before, which implies the need of fortress-like capital levels at the GSEs. The difficulty in enacting funding legislation for the TARP in 2008, and its subsequent unpopularity, makes clear the danger of assuming that Congress will promptly step in to bail out the GSEs, if necessary. It is a serious misconception that taxpayers and housing finance markets are adequately protected if the GSEs hold enough capital to cover ultimate credit losses in a scenario as severe as that experienced in 2008 to 2012. Capital must be sufficient to demonstrate to market participants that they should be willing to accept prices on the GSEs' debt that allow them to continue to operate during a stress event. No matter how bad conditions are, these participants will inevitably fear that conditions will worsen further, until it is clear that conditions are in fact improving. Market reaction to the Covid-related stress in the Spring of 2020 demonstrated again that risk perceptions at their peak will generally greatly overstate ultimate losses. Prices of securities that exposed holders to some of the GSEs' credit risk fell sharply early on but later recovered as it became clear that losses were unlikely to be as severe as initially feared.

Our capital accounting principles ensure that foreseeable future losses (that may never occur) must be taken in advance, and mere solvency after those losses are taken is not sufficient for the willingness of market participants to continue offering credit on reasonable terms. Thus, by 2011, Fannie Mae had written off 80 percent more losses than it ultimately incurred, and worst-case projections of its own regulator contemplated an additional 65 percent further plausible but unexpected losses. In 2008, Fannie Mae might have needed to start with enough capital to cover three times the amount of its ultimate losses to convince investors in late 2011 that it would remain sound in the following years. It is a widely accepted principle that if regulatory standards are so tough that no commercial banks fail, they are too tough. That is not the case with these GSEs. Given their market dominance, failure could be catastrophic. This is precisely why the Obama reform plan called for winding down Fannie Mae and Freddie Mac, shrink the government's footprint in housing finance, and help bring private capital back to

[1] "The [Obama] Administration's plan will wind down Fannie Mae and Freddie Mac and shrink the government's current footprint in housing finance on a responsible timeline.", https://www.treasury.gov/press-center/press-releases/pages/tg1059.aspx, February 11, 2011

the mortgage market."[2] Given that this plan was not implemented and the continuing reliance on the GSEs, it is mandatory that any capital regime assure that they will not fail.

We have argued in comments on previous GSE capital proposals that more capital was needed. We were pleased that the 2020 proposal was tougher than that of 2018, and that the 2020 final rule was stronger still. But the current standards are still too weak.

The Proposal Would Substantially Weaken GSE Capital Mandates

Ideally, in a capital regime that has both a risk-based and a leverage standard, the risk-based standard will be usually, or at least frequently, the binding capital constraint because it is more likely to incent prudent risk management. That is not the case with the GSE standard for one of the GSEs. FHFA is concerned, in particular, that the GSEs' credit risk transfer (CRT) programs may be underutilized in consequence. Indeed, Fannie Mae has not reentered the market for risk transfers since the covid-related market instability in the spring of 2020, even though the CRT markets have recovered nicely. FHFA's solution is to give more benefit to CRT transactions in calculating required risk-based capital, and, more significantly, to reduce the buffer component of the required leverage ratio. The total mandated leverage amount, including both strict requirement and buffer, would drop from four percent for each GSE to three percent for Fannie Mae and 2.9 percent for Freddie Mac. In its fact sheet accompanying the proposal, FHFA concludes that had the changes been in effect March 31, 2021, the combined GSE capital requirement plus buffer "would have declined modestly from $316 billion to $300 billion," or about five percent. The numbers shown appear to reflect the sum of each GSE's respective binding requirement plus buffer. Thus, the larger number adds Fannie's risk-based amounts and Freddie's leverage amounts under the current rule, and the smaller number is the sum of each GSE's risk-based amounts.

This is seriously misleading for two reasons. First, it ignores the composition, or quality, of capital. The risk-based standard may be met in part with tier 2 capital, including subordinated debt, which, as we have previously commented, is of little value for GSEs. In creating the current conservatorships in 2008, for example, subordinated debt investors were fully bailed out, contributing absolutely zero absorption of losses. The more relevant comparison is based on the standards for tier 1 capital, which is mainly common and preferred stock. For the two GSEs combined, the tier 1 mandate falls by 16 percent, or $48 billion—three times as much as the comparison in the fact sheet. Second, the decline for Freddie Mac is considerably more using either comparison, and Freddie's data appear to be far more relevant under current circumstances. The reduction for the combined GSEs in the fact sheet comparison gives heavy weight to Fannie's results, which reflect only the more limited changes in the risk-based requirement, as that standard would have been binding for Fannie under either the current rule or the proposal. Fannie's lack of participation in CRT activities over the past 18 months, just what the rule changes are designed to reverse, likely accounts in large part for its higher risk-based requirement. Freddie Mac's data provide a better perspective on the effect of the rule change going forward. In its case, the mandated amount of tier 1 capital under the proposal is 23 percent less than under the current rule (as best we can calculate using the rounded data FHFA has disclosed). If Fannie Mae were

[2] Ibid.

induced by the rule change to reduce its risks as Freddie has, the effect on its capital needs would be comparable to what Freddie would enjoy.

There are much better ways to address FHFA's underlying concerns

Fannie Mae's lack of participation in CRT markets over the past year clearly indicates that some action by FHFA must be taken. While Freddie Mac's management has dutifully resumed its CRT transactions, Fannie's management apparently sees no advantage in doing so. FHFA correctly points out that, while the GSEs are in conservatorship, a failure to share risk with others leaves taxpayers holding the risk. The GSEs have only tiny amounts of capital currently, and what little they have is essentially a gift from taxpayers in the form of changes granted by FHFA and Treasury to the Senior Preferred Stock Purchase Agreements (PSPAs), agreements without which the GSEs would be unable to function. Those changes allow the GSEs to build capital through retained earnings. As long as times are good, money spent on insurance in the form of CRT deals reduces earnings and therefore capital growth, making an escape from conservatorship more difficult. If times turn bad, what little capital they have accumulated would likely be quickly exhausted. As FHFA has left a GSE's decision about whether or not to use CRT to the GSE's judgement on the "sensibility" of doing so, changing the capital rule may have little effect in incenting greater risk transfers.

The obvious short run remedy if FHFA is unhappy about Fannie Mae's choice is simply for FHFA to instruct Fannie Mae to immediately get back in the CRT business and make up for lost time. As conservator, FHFA has all the powers and authorities of each GSE's management and Board of Directors. FHFA bears responsibility for all GSE policy decisions and actions while in conservatorship. Should a GSE ever leave conservatorship, much the same result could be achieved through new regulations concerning the importance of CRT to safe and sound operation or through new amendments to the PSPAs as part of the conditions for leaving. FHFA should mandate greater use of CRT structures and marketing approaches that attract investors likely to maintain an active role in difficult markets. FHFA should also mandate greater reliance on upfront credit enhancements, this those that locked in either at the time of origination or when the mortgages are acquired by the GSEs.

A capital regulation incentive should be only in addition to the direct approach to maintaining CRT usage. It is certainly desirable for a risk-based measure to be binding during at least a significant part of the housing cycle. But given that the current rule's requirements and buffers are too weak, the right way to correct any imbalance is to raise risk-based standards, not to lower leverage standards. In our comments on FHFA's earlier proposals, we argued that a risk-based standard averaging about five percent over the cycle would be about right. That would allow for coverage of losses during a stressful environment comparable to 2008-12 on loans meeting the GSEs current standards, the inevitable overshooting of loss anticipations at the worst point in the cycle, and some additional capital to give some confidence to investors that the GSEs could survive further unanticipated problems. In particular, we recommended adding a 50 basis-point capital charge to explicitly cover model risk, an additional 10 basis points to cover operational risk, and applying the countercyclical adjustments in all market environments, not just when real house prices deviate from trend by more than five percent, as in the current rule. Absent such improvements, the FHFA's proposed amendments to its treatment of CRT coverages add to the already excessive amount of taxpayer risk.

In passing we note that the recent response of house prices to the Federal Reserve's extraordinarily low interest rates and the rapidly recovering economy highlights the wisdom of including the innovative countercyclical adjustment in the rule. As we discussed above, though, the impact of capital incentives in conservatorship are apparently muted. One of the advantages of the adjustment was to provide a capital cost signal to the GSEs when prices are soaring that risks are rising and an increase in guarantee fees is appropriate. FHFA repeatedly notes in its proposal documents that the GSEs are meant to serve a countercyclical role. Rather than loosening restraints on second homes and other investor properties, we urge FHFA to instruct the GSEs to stop fueling surging house market prices which buildup risk on their balance sheets and increasingly leave low- and moderate-income purchasers behind.

Our suggestions would strengthen Enterprises' resiliency under stress, reduce the severity of extreme market disruptions, and reduce the need to make *ad hoc* exceptions under such conditions.