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Federal Housing Finance Agency
Division of Resolution
400 7th Street, S.W.
8th Floor
Washington, D.C., 20219

Re: Arch MI's Response to the Notice of Proposed Rulemaking to Amend the Enterprise Regulatory Capital Framework ("ERCF")

Ladies and Gentlemen:

Arch Capital Group Ltd., on behalf of itself and its subsidiaries ("Arch"), submits this letter in response to the Federal Housing Finance Agency's ("FHFA") notice of proposed rulemaking ("NPR") to amend the ECRF, including amendments to the Prescribed Leverage Buffer Amount ("PBLA") and Credit Risk Transfer ("CRT") (the "2021 Amendments"). Arch, through its insurance subsidiaries, provides commercial, institutional, and individual customers with mortgage, property-casualty, and reinsurance offerings on a worldwide basis.

Arch's subsidiaries, Arch Mortgage Insurance Company and United Guaranty Residential Insurance Company, (together "Arch MI") is a leading mortgage insurance provider in the United States, having $280.4 billion of insurance in force as of September 30, 2021. Arch's reinsurance subsidiaries are also leading investors in Fannie Mae and Freddie Mac's (together, the "GSEs" or "Enterprises") CRT programs. Arch has made a long-term strategic commitment to the U.S. mortgage market, investing in, managing, and distributing credit risk in a variety of single family and multifamily executions. Arch has developed its own internal credit risk and econometric models and invests heavily in the intellectual capital required to support underwriting decisions and risk management. Thus, Arch is well-positioned to provide input on the 2021 Amendments.

Arch commends the FHFA for proposing targeted amendments to the ECRF that was finalized on December 17, 2020 ("2020 Rule"), which was a re-proposal of the conservator capital framework proposed in 2018 ("2018 Rule"). FHFA's proposed 2021 Amendments eliminate the distortions in the 2020 Rule that incented the GSEs to increase risk taking, risk retention and a return to the failed "buy and hold" business model of the past. Importantly, FHFA's amendments are *targeted* and do not purport to overhaul the capital framework and the tremendous work done by the agency and industry stakeholders to establish and improve the ECRF over the past three years. Maintaining a durable capital standard across market cycles and varying political administrations is vitally important to maintaining market stability, and FHFA's proposed amendments nicely achieve this balance.

Arch's general comments, in Section I, address the amendments to CRT and the incentives and disincentives resulting from the amendments.[1] Following, Arch recommends one adjustment. Principally, the FHFA should adjust the credit risk capital required for retained CRT exposures in the super-senior tranche (also known as the "AH tranche") to create an incentive for the GSEs to purchase protection above stress losses. Doing so would mitigate the model risk inherent in forecasting stress losses (which is used to set the CRT detachment point), address the lack of fungibility of CRT capital across structures, and further enhance the safety and soundness of the Enterprises. The remainder of Arch's comments, in Section II, are responsive to FHFA's additional queries.

Section I. General Comments

A. Evolution of CRT Treatment Under Risk-Based Capital Requirements.

The graph in Chart 1 below illustrates the evolution of the deductions to CRT capital credit between the 2018 Rule, the 2020 Rule and the 2021 Amendments with the following assumptions in a stylized example, which reflects a typical CRT structure.

- CRT Attachment Point Based on Expected Losses = 35 bps
- CRT Detachment Point Based on Stressed Losses = 335 bps

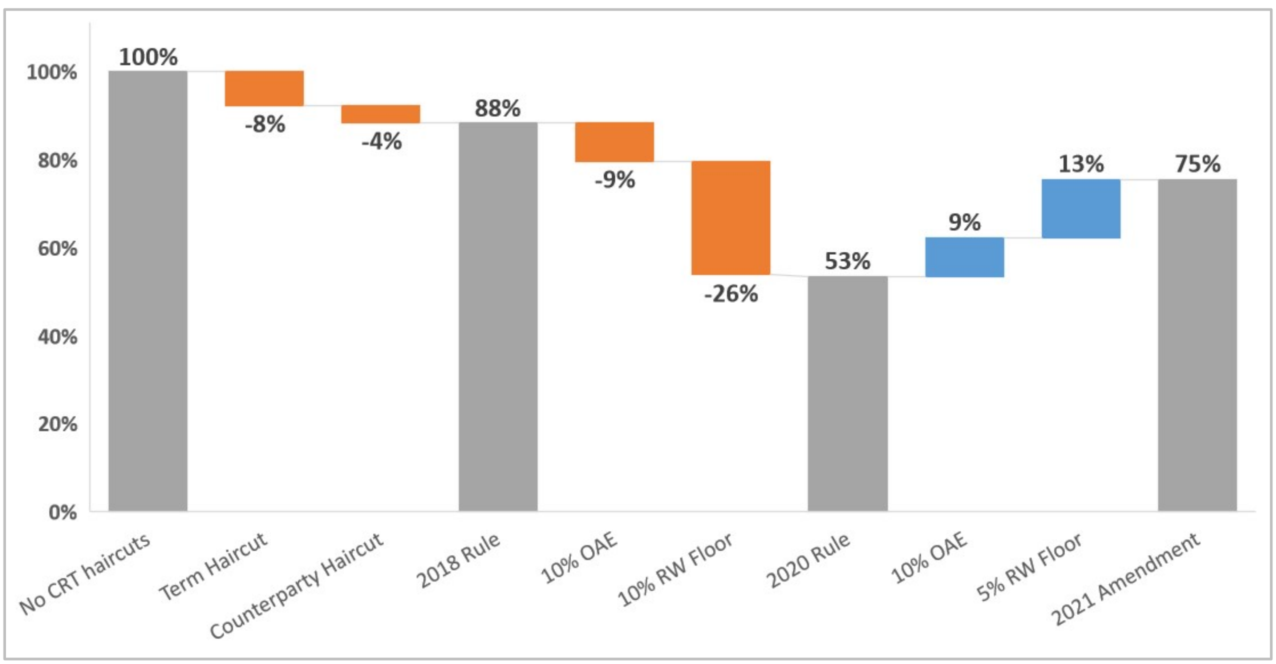

Chart 1 – Risk-Based Capital Credit for CRT under Stylized Example

[1] Arch's General Comments address Questions 5-8 in the NPR.

With no haircuts and assuming CRT attaches at expected loss and detaches at stress loss then the capital credit is 100%. The 2018 Rule included small deductions for timing and reinsurer counterparty strength, which reduced the overall credit to 88%. The 2020 Rule included two additional significant deductions, a 10% overall effectiveness adjustment ("OEA") and a 10% CRT risk-weight tranche floor, which further reduced the capital credit to 53%. The 2021 Amendments propose to modify these two additions by reducing the CRT risk-weight tranche floor to 5% and eliminating the OEA. The proposed changes increase capital credit for CRT to 75%. The cumulative CRT haircuts applied to the assumed structure is reduced from approximately 47% under the 2020 Rule to approximately 25% under the 2021 Amendments.

Arch supports FHFA's adjustments under the 2021 Amendments, which meaningfully restore the incentive for the GSEs to engage in CRT, while maintaining a conservative discount to equity capital. With one enhancement (described below), Arch believes that the increased capital relief for CRT proposed in the 2021 Amendments will strengthen the safety and soundness of the GSEs and their ability to fulfill their statutory missions to provide stability and ongoing assistance to the secondary mortgage market across the economic cycle.

B. Recommended Adjustment to Incent Purchasing CRT Protection Above Stress Losses

While the 2021 Amendments restore the capital incentives for the GSEs to cede credit risk to external parties, thereby de-risking the GSEs balance sheets and the risk to taxpayers, the 5% risk-weight tranche floor incents the GSEs to retain all catastrophic losses (i.e. above *estimated* stress losses). In the example above, ceding risk above 335 bps would not be "economically sensible." As noted by FHFA in the 2021 Amendments:

> Market conditions in addition to a transaction's cost and structure ultimately determine a CRT's relative profitability, but if CRT premium payments are low relative to the capital reduction provided by the CRT, then the Enterprise has the opportunity to execute *economically sensible* CRT transactions, and CRT may provide taxpayer protection at a lower cost than equity capital [emphasis added].[2]

Without the ability to reduce the 5% risk-weight tranche floor, the tradeoff between ceding premium relative to the capital reduction does not exist and the GSEs are incented to self- insure catastrophic risk.

Arch believes the incentive to self-insure all catastrophic risk should be modified for two primary reasons. First, the estimate of stress losses, which informs the CRT structure detachment point, is an estimate and is inherently subject to model risk. Second, CRT capital is not fungible between transactions covering different pools of loans as is equity capital. For example, if losses under an actual stress are 350 bps on Transaction A and 320 bps on Transaction B, both of which had modeled stress losses at inception and CRT detachment points of 335 bps, the 15 bps

[2] FHFA's NPR re: Amendments to the Enterprise Regulatory Capital Framework Rule – Prescribed Leverage Buffer Amount and Credit Risk Transfer, pg. 18.

redundancy on Transaction B cannot cover the deficit on Transaction A. As such, the GSEs should be incentivized to purchase protection marginally above stress loss to decrease the risk associated with this lack of fungibility. Thus, Arch recommends that the FHFA modify the capital relief for CRT to incent the GSEs to purchase CRT protection above stress losses and suggests that one practical way to do so is to allow the GSEs an offset to the 5% risk-weight tranche floor.

Continuing with our example, the 5% risk-weight tranche floor equates to approximately 40 bps of reduction to CRT capital relief.[3] A simple way to embed an incentive in the ECRF to purchase protection above stress losses could be to give an offset to the 40bps risk-weight tranche floor haircut, up to, say a 50% offset (reducing the haircut to 20bps), as illustrated in Chart 2 below.

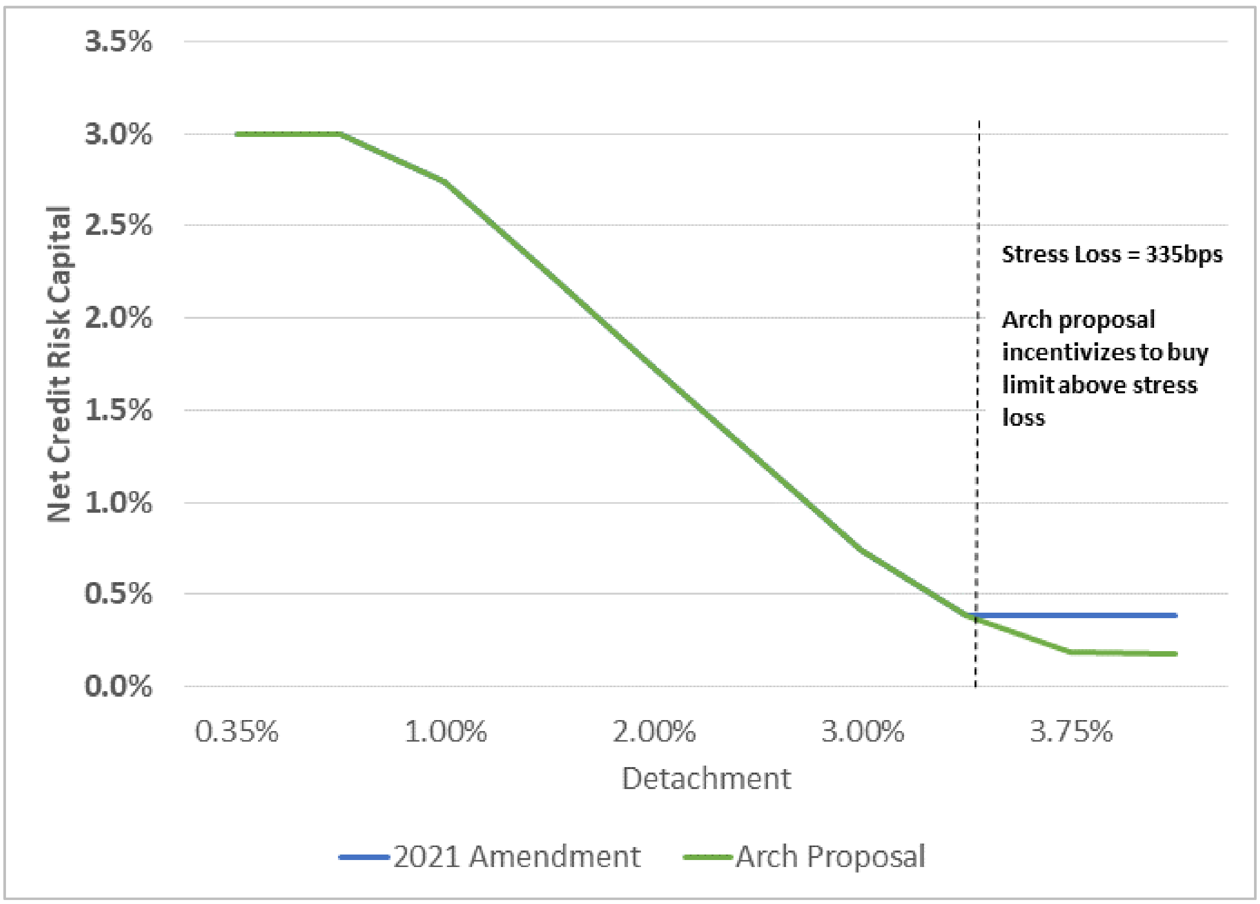

Chart 2 - Net Credit Risk Capital at t=0 at Varying Detachments under the Stylized Example

Chart 2 illustrates the application of the 50% offset if the transaction detaches at 375 bps. The limit purchased above stress loss equals 40 bps. Arch is suggesting the limit subject to offset be capped to a maximum of the 5% risk-weight floor, which is 40 bps. Thus, in the example above,

[3] 40 bps is the product of the 5% risk-weight tranche floor, the 8% capital charge in the ECRF, and the ~96% of risk retained in the AH tranche.

detaching at 375 bps would result in a 20 bps (40 bps * 50%) reduction to credit risk capital required for the transaction. If, for example, the detachment point was set at 350 bps, which is 15 bps over stress losses, the reduction would be 7.5 bps.

The 50% offset would incentivize the GSEs to better manage their exposure to catastrophic risk by evaluating the trade-off between ceding a portion of premium to the capital reduction and risk reducing benefits from purchasing additional cover. In addition, purchasing catastrophic coverage slightly above the stress loss detachment point would likely reduce the weighted average cost of CRT capital since coverage so high in the stack is relatively inexpensive, and investor appetite at this level has historically been robust.

Under the 2021 Amendments, the 5% risk-weight tranche floor results in a discount of approximately 10.0%-13.3% for retained CRT exposures in the super-senior tranche, where potential losses are most remote. Relative to the comparison of CRT credit illustrated in Chart 1 above, if Arch's proposal is adopted, the overall capital credit for CRT credit would increase from 75% to 81%. Arch believes that this proposal creates a win-win-win solution for the FHFA, the GSEs and CRT investors. Arch's suggested adjustment would mitigate model and fungibility risk, while appropriately preserving a conservative discount to CRT capital when compared to equity capital and promoting safety and soundness.

Section II. Arch's Responses to FHFA's Additional Questions

Further to the general comments made herein, Arch submits the following responses to the remaining queries in the NPR for FHFA's consideration:

Question 1: What approach that relies only on non-proprietary data or indices should FHFA consider to mitigate the pro-cyclicality of the credit risk capital requirements for multifamily mortgage exposures?

Response: Arch reiterates the response supplied in its comment letter to the proposed 2020 Rule, which is summarized herein for ease. Arch is not aware of any non-proprietary data or indices that could be used to develop a reliable long-term trend in multifamily property values. Given this limitation, Arch recommends for FHFA's consideration two potential alternatives to address the pro-cyclicality of the credit risk capital requirements for multifamily exposures.

Given the reliance of the multifamily base grids on mark-to-market ("MTM") loan-to-value ("LTV") and MTM debt service charge ratio ("DSCR"), increasing property values and DSCR (driven by increases in income) will drive a reduction in required capital in a strong economy, while under stress, required capital would increase at a time when capital is scarce. To mitigate this swing in required capital, Arch recommends the FHFA consider the following alternatives:

1. The FHFA could evaluate, with input from market participants, a point in time when the multifamily market is deemed to be fairly valued. Long-term property/income values could be assumed to increase at ~3-5% per annum (or another long-term growth rate deemed

reasonable), and "adjusted" MTMLTV/DSCR could be calculated similar to the single-family countercyclical adjustment. While imperfect, this approach would remove much of the pro-cyclicality within the proposed framework.

2. Alternatively, FHFA could revert to using original LTV and DSCR. While we recognize that default propensity decreases as multifamily properties build equity and income levels, required capital should not decrease when property/income values exceed long term growth rates. Reverting to original LTV and DSCR, which typically produces a more conservative capital requirement in a growing economy, is better for the long-term stability of the housing finance system than a pro-cyclical capital requirement.

Questions 2 and 3: Is the proposed PLBA appropriately formulated? What adjustments, if any, would you recommend? Is the PLBA necessary for the ERCF's leverage framework to be considered a credible backstop to the risk-based capital requirements and PCCBA?

Response: The proposed replacement of the fixed leverage buffer with a dynamic buffer reinforces the risk-based focus of the ERCF by reducing the potential for the leverage capital requirement to be the binding capital requirement for the Enterprises. As Arch noted in its comment letter submitted in response to the 2020 Rule, an excessively high leverage requirement that regularly surpasses risk-based capital requirements could distort decision making and encourage the Enterprises to forgo lower-risk assets in favor of those with higher-risks because the same capital requirement would apply for either asset.[4] A binding leverage ratio would also remove all capital incentives to cede risk to third parties. As noted by FHFA, "[i]t is possible that in the absence of risk transfer, required capital may increase faster than retained earnings and the Enterprises may therefore grow farther from achieving capital adequacy and exiting their conservatorship."[5] In Arch's opinion, the dynamic buffer, set at 50% of the stability buffer, reduces the overall leverage amount such that it would rarely be binding, while remaining an overall credible backstop calibrated to withstand losses in excess of the great financial crisis.

Question 4: In light of the proposed changes to the PLBA and the CRT securitization framework, is the prudential risk weight floor of 20 percent on single family and multifamily mortgage exposures appropriately calibrated? What adjustments, if any, would you recommend?

Response: Arch appreciates the rationale for including a minimum risk weight floor in the ECRF and agrees that establishing such a floor is prudent to ensuring the safety and soundness of the Enterprises. In particular, the floor mitigates the risk that FHFA's stress loss estimates on low-risk exposures are calibrated too low and that the underlying collateral is not covered by CRT. Arch thus supports the higher loan level risk-weigh floor of 20% to incentivize the GSEs to transfer credit risk on lower-risk exposures.

[4] Arch Capital Group Ltd's Letter on the Re-Proposed Enterprise Capital Rule, submitted August 28, 2020, pg. 14.
[5] FHFA's NPR at pg. 25.

Conclusion

Thank you for the opportunity to provide comments, and more broadly for the agency's commitment to consider feedback from industry stakeholders when implementing important changes. Arch firmly believes that effective collaboration between FHFA, industry stakeholders and housing policy experts produces better outcomes for all. For example, in response to the proposed 2018 Rule, Arch suggested implementing a countercyclical capital adjustment, which is one of the enhancements adopted by FHFA in the 2020 Rule. The 2021 Amendments put forth are *targeted* and build upon the tremendous work done across administrations in collaboration with the industry stakeholders to create the ECRF. With the adoption of the Arch proposal detailed herein, we believe that FHFA can finalize a robust and durable regulatory framework that ensures the Enterprises operate in a safe and sound manner consistent with their statutory purposes. Arch remains committed to working collaboratively with the FHFA and would be happy to discuss further at FHFA's convenience.

Sincerely,

David Gansberg