American Bankers Association
Building Success. Together.

Hu A.Benton
Senior Vice President and Policy Counsel
202-663-5042
hbenton@aba.com

November 23, 2021

The Honorable Sandra Thompson
Acting Director
Federal Housing Finance Agency
400 7th Street, SW Washington, DC 20219

Re: Notice of Proposed Rulemaking and Request for Comments – RIN 2590-AB17

Dear Acting Director Thompson,

The American Bankers Association (ABA)[1] appreciates this opportunity to comment on the Federal Housing Finance Agency's (FHFA) proposal to amend the Enterprise Regulatory Capital Framework (ERCF) by refining the prescribed leverage buffer amount (PLBA or leverage buffer) and credit risk transfer (CRT) securitization framework for Fannie Mae and Freddie Mac (the Enterprises or GSEs).[2]

Both PLBA and CRT play important roles in the prudential regulation of the Enterprises. The proposed refinements may have significant impacts on the management of the Enterprises, the continued availability of mortgage credit to the primary market, the protection of taxpayers, and the interplay between the Enterprises and the private mortgage market, both now and in a post-conservatorship environment. With those impacts in mind, we offer the following comments reflecting the views and insights of our members, which we hope will be useful in further refining and finalizing the proposal.

Summary of Comments

Reducing the risks held by the Enterprises – both during the ongoing conservatorship and in a post-conservatorship environment, is one of the most important responsibilities of the FHFA. This task is made more complex by the fact that the tools available and how they can best be deployed will differ under changing circumstances, not least of which include what ultimate form the Enterprises take in a post conservatorship environment. The current proposal's effort to revise and refine the PLBA, CRT and other tools reflected in the current proposal are important

[1] The American Bankers Association is the voice of the nation's $22.8 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard nearly $19 trillion in deposits and extend nearly $11 trillion in loans.
[2] https://www.govinfo.gov/content/pkg/FR-2021-09-27/pdf/2021-20297.pdf.

steps, but need further refinement, supported by additional research, and the development of metrics to better determine the degree to which tools such as CRT should be deployed.

ABA remains neutral on the question of the appropriate post conservatorship corporate structure of the Enterprises. For purposes of these comments, we presume there will not be legislation enacted in the near term altering the shareholder ownership status that existed prior to conservatorship, and that is the structure to which they will eventually return.

The proposed change to the PLBA may have unintended adverse impacts on the Enterprises' ability to support the market when they are most needed.

FHFA proposes to decrease the PLBA from 1.5% of Adjusted Total Assets to 50% of an Enterprise's Stability Capital Buffer. While a leverage ratio, including a PLBA, can serve as a credible backstop to risk capital rather than supplant an RBC regime, ABA is concerned that such a ratio can become a binding constraint at precisely the time when GSEs are most important for market liquidity. We also recognize, however, that a leverage ratio can be a tool to limit unconstrained growth in Enterprise market share.

The overall goal of eliminating leverage ratios as the binding constraint in other than remote circumstances is one of the most important aspects of the proposal, both to promote appropriate market support and to avoid incenting risky lending. A leverage ratio test based on market share, if not calibrated to avoid constraint except as a last resort, could significantly limit the Enterprises' ability to supply market liquidity when it is most needed – when other providers step back from the market.

The proposed change to the PLBA would tighten leverage ratio constraints based on growth in the Enterprises' market share. The circumstances under which market share growth seems most likely to occur would be situations in which the Enterprises continue to increase their books of business when other market participants are growing their businesses more slowly or are actually shrinking. These circumstances seem most clearly to be the ones in which the Enterprises should support the market. Though a PLBA that includes a factor based on the Stability Capital Buffer could avoid this undesired effect, it arguably would have to be set such that it becomes relevant only at extreme levels of market share growth. It is not clear that the benefits of such an approach, in terms of Enterprise safety and soundness, would be significant.

As an alternative, ABA recommends that FHFA consider adapting the PLBA to enhance Enterprise capital levels in periods of healthy or rapidly expanding market activity, enabling leverage ratio flexibility when market conditions change and require greater Enterprise support. If the PLBA were calculated such that a total leverage ratio in normal or rapidly expanding markets included a non-zero variable element, FHFA would have the option of easing capital constraints if the need for Enterprise market support increases.

Although the proposal to tie a capital increase to Enterprise market share growth without consideration of broader market conditions will not, in itself, facilitate the Enterprises' market support role, a PLBA that is higher at times of general market expansion, but flexible, is consistent with that role. A reasonable capital constraint on further Enterprise growth in such

expanding conditions would further Enterprise safety and soundness. It may also provide a mechanism for damping market pressures in general and avoiding bubble conditions. When market conditions deteriorate and the Enterprises' special support role becomes important, this PLBA element could be eased to facilitate market support.

ABA's proposed change to the PLBA would clearly require calibration to assure that the total leverage ratio provides an appropriate backstop during normal or expanding market conditions, as well as enough "margin" to permit easing during periods of market stress (when Enterprise support is most critical) without compromising safety and soundness. It would focus on dynamic mortgage market conditions and thus would be distinct from other macroprudential aspects of the ERCF. ABA believes that would appropriately reflect the unique nature of the Enterprises' market support role and could be implemented consistent with Enterprise safety and soundness financial market stability objectives. ABA also believes it would be consistent with FHFA's overall objective to reduce the pro-cyclical aspects of regulatory capital requirements.[3] Whether such a flexible PLBA element should become effective in the discretion of FHFA, or whether it should be implemented using a predetermined formula is a matter for further study and consideration.[4]

Application of CRT as a risk mitigant should be more refined and flexible in order to assess its effectiveness compared to the cost of capital on a dynamic basis.

As we have noted in past comments, CRT is a valuable tool developed during conservatorship, and we support continued development and use. CRT has become an important tool for management of Enterprise credit risk during a period in which other tools, particularly increased shareholder equity, have not been available. As long as the Enterprises remain in conservatorship, and even after, we expect CRT to remain an important and even dominant tool. But it should not, especially in a post conservatorship environment, be the only tool, and its use must be calibrated for efficiency.

The Enterprises have aggressively pursued business in the 2018-2021 period, which – combined with historically rising home values – has grown their combined guaranty book of business to almost $7 trillion as of Q2 2021. However, it is unrealistic to expect the mortgage market to continue expanding at such an aggressive rate and for the Enterprises to continue to grow their books and capital by retaining earnings at the same rate. In the recent mortgage and economic environment, ABA believes that CRT is one choice among loss-absorbing tools, as we will discuss below. While ABA believes that CRT can be a valuable tool, that value can change with changing circumstances. ABA urges the use of a flexible combination of CRT, capital, (and other risk transfer mechanisms that may be developed). In order to determine that the appropriate

[3] *See* C:\Users\tcardwell\AppData\Local\Microsoft\Windows\INetCache\Content.Outlook\ZQ4KGM63\CRT Capital Amendments 9-2021.pdf*85 Fed. Reg. at 82,165 (December 17, 2020)*.

[4] On one hand, a predetermined formula would be more transparent. On the other hand, retaining a role for application of FHFA judgment would permit tailoring of leverage ratio constraints, within prescribed limits, to address actual market conditions. The Enterprises would arguably be better able to participate in markets across a wide range of conditions, which, in turn, would enhance their ability to attract private capital following termination of the conservatorships.

mix, it will be necessary to develop a reliable method to determine the cost of capital vs. the cost of CRT and other risk reduction transactions. Furthermore, it will be necessary to base this analysis rigorously on loan underwriting standards and credit risk assessment of the underlying mortgage assets.

As important a tool as CRT has been become during the conservatorship period, ABA suggests that there are other ways of looking at CRT, and that product refinements, and other types of capital management, should also be considered by FHFA. Many of our comments to Part III, B, of the proposal follow from this suggestion.

Part III, B Responses

Question 5: Is the 5 percent prudential floor on the risk weight for a retained CRT exposure appropriately calibrated? What adjustment, if any, would you recommend?

CRT securities are similar in some respects to other mortgage-backed securities structures that have been used in the past and currently. CRT structures channel credit risk while private-label structures usually channel both credit and interest rate risk. The senior/subordinated structure that has been used in some Enterprise multifamily CRTs is virtually identical to similar securitizations used 15 or 20 years ago in private-label single family securitizations. Even the re-insurance tranche that is widely used by both Fannie Mae and Freddie Mac in the M1 tranche of their most common single-family CRT structures is analogous to the use of monoline credit guaranties on selected tranches of private-label MBS used in the last 30 years of structured finance. The risks attendant to CRT structures, much like private-label structured finance vehicles, will become most apparent only when there is a downward cycle in house prices. CRTs do not necessarily transfer away all risk. For example, the credit risk in the reference portfolio may be bigger than the amount covered by the CRT transaction, similar to first-loss and mezzanine sub tranches being too small.

It is unclear how the proposed 5% prudential floor on the risk weight for a retained CRT has been calibrated. It is merely half as much as the previous 10% floor. Given that the 10% minimum floor was instituted less than one year ago, it is unclear how FHFA would now determine to lower it by half. The rationales stated in the proposal include, "CRT should be evaluated relative to the cost of equity capital needed to self-insure the risk"[5] and "CRT may provide taxpayer protection at a lower cost than equity capital."[6] Currently, the Enterprises have no shareholders to whom they have an obligation to earn a return and therefore that have no explicit cost of equity. It is at best difficult to calibrate the cost of equity explicitly. There is nothing in the proposal that reveals either the Enterprises' or FHFA's views of required returns on capital in the future, but presuming an eventual release from conservatorship and a return to shareholder ownership, one can surmise that expected returns would increase and that the effectiveness of CRT relative to incremental capital would need to be re-evaluated. Furthermore, in the current environment, with conservatorship ongoing, a lack of competition from other secondary market participants and an ongoing shortage of affordable housing options, CRT structures would seem to offer continued promise.

[5] 86 *Fed. Reg.* at 53,234 (September 27, 2021).
[6] *Ibid.*

FHFA should adopt specific, flexible approaches to setting an appropriate risk weight for retained, inherent CRT risks.

To reduce some of the risks still inherent in CRT transactions, ABA would support FHFA lowering the specific risk weight under certain criteria, for example, in cases in which:

1) The single-family CRT securitization itself, or the loans making up the CRT securitization, were seasoned, ***and***
2) There was a transparent way to demonstrate that the houses underlying the Reference Pool's mortgages had significantly appreciated in value versus the remaining mortgage debt, taking amortization into account. For example, a lower capital level might be appropriate if the ELTV[7] was 12% or more lower than the original loan to value (OLTV) of the Reference Pool.)

The time interval for such a reduction in risk weight following initiation of the CRT might be (if the seasoning and ELTV/OLTV criteria were met):

- Lowered from 10% RWA to 7% after 3 years,
- Lowered from 7% to 6% after 4 years, and
- Lowered from 6% to 5% after 5 years. This could apply to both 10 year and 12.5 year structures.

These are illustrative suggestions of how to address reducing the risk weighting. ABA recommends that FHFA undertake and publish testing to come up with exposure-specific (*i.e.,* CRT-specific) methods before allowing any more capital relief. As with any risk management decision, the granting of capital relief on CRTs should be done using – to the greatest extent possible – exposure-specific information in the context of current and expected future economic factors, which are readily available.[8] ABA cautions that any broad-brush changes to risk weighted assets (RWA) in ways that would apply to *all* CRT exposures should be avoided. Since CRT securities are similar to highly structured MBS, changes in risk should be viewed based on both the structure of the security and the qualities (seasoning, remaining life, ELTV, etc.) of the loan collateral.

Question 6: Is the removal of the overall effectiveness adjustment (OEA) within the CRT securitization framework appropriate in light of the proposed rule's 5 percent prudential floor on the risk weight for retained CRT exposures?

No. The effectiveness adjustment should remain as is. The OEA affects only the M1 security. The M1 security is basically a negotiated trade (via bidding) where the parties implicitly decide the probability of the break-point between expected loss (EL) and unexpected loss (UL). Each M1 security's risk is also highly sensitive to prepayment risk (discussed below). The existing OAE that is formulated in the existing ERCF should remain as published in December, 2020,

[7] ELTV is Freddie Mac terminology for valuations performed by automated valuation models. Such information is already available to single-family CRT investors.
[8] Both Enterprises offer information regarding single-family Reference Pool characteristics for each deal.

and as illustrated on pages 43-45 of the NPR. The OAE was applied in order to not give too much *ex ante* capital relief. Keeping the OAE component would be consistent with the suggested approaches we outlined above regarding the question of lowering the risk weights on the AH tranche.

Question 7: Is the proposed approach to determining the credit risk capital requirement for retained CRT exposures appropriately formulated? What adjustments, if any, would you recommend?

As discussed above, ABA encourages FHFA to take a more expansive view of CRT transactions and look at risk weights in a less "one size fits all" approach. There are identifiable loan-specific and structure-specific data that are better tools to use in determining the capital relief to allow for particular CRT Reference Pools and structures. Also, the prepayment experience and current credit trends – in light of a more "normal" market environment – of both the pools and the larger market should, or could, be considerations for FHFA. A "normal" environment might be somewhere between the experience of the past 5-6 years and where severe stress scenarios would indicate.

As also discussed above, ABA recommends that FHFA undertake a review of overall CRT risk transfer effectiveness from inception to date. The review should consider: the loss performance of the pools, how much guarantee-fee income the Enterprises conceded to the M1 security-holders and to reinsurers, how fast the collateral repaid, and thus whether the CRT was effective in transferring actual risk (loss) at a reasonable cost. The question raised in the proposal and elsewhere is whether the CRT structures have largely been "g-fee transfer transactions" where the Enterprises have bargained away guarantee-fee income disproportionate to the loss (EL and UL) that is transferred to the holders of the M1 security. Such an examination may also consider that the recent experience of very heavy loan refinancing and very favorable credit and house price trends may not continue. Recent years' mortgage markets have enjoyed a benign environment, as far as credit experience. ABA suggests that any analysis be undertaken at the FHFA's direction, perhaps by an independent third party, and published before any reformulations of the credit risk capital requirement for retained CRT exposures be undertaken. This analysis should also test how securities and their associated reference pools would have performed under far different circumstances, and that analysis should also be publicly available.

Ultimately, the analysis of CRTs' effectiveness as a loss-mitigation tool should be a comparison to the cost of specific transactions relative to the cost of Enterprise capital that would adequately support the risk over the expected time horizon of effective loss mitigation if the risk were retained instead of being transferred. This comparison is necessary to determine the CRT cost's "reasonableness" referred to above. Expressed differently, for transfer of a given degree of risk, if the guarantee-fee income that would be required by the CRT investors exceeds the cost of capital the Enterprise would incur to hold the Reference Pool without execution of the CRT, the CRT would be uneconomic. A careful, conservative analysis based on these principles would be

more rational than a goal for CRT transactions set as single percentage of assets, regardless of their cost relative to the cost of capital.[9]

ABA believes that a rigorous and conservative analysis along these lines would significantly reduce or eliminate the risk of CRT investors "cherry-picking" Enterprise portfolios. An accurate assessment of the reasonableness of CRT pricing would reveal potential for overpayment for loss protection (relative to the cost of equity) for the degree of risk assumed and actually removed from the Enterprise's portfolio. ABA believes that disciplined application of this approach, which would take account of market conditions and investor expectations,[10] would in the near term avoid both retention of excessive risk when CRT executions provide cost-effective alternatives to self-insurance and inappropriate overpayment (and loss of earnings) as the Enterprises seek to build capital ahead of a conservatorship exit. Moreover, a credible and transparent approach should facilitate conservatorship exit by building credibility for the Enterprises' fundamental risk management competencies.

This approach acknowledges the important principle that FHFA's intention in adopting the ERCF was to establish a regulatory capital regime that will be effective post-conservatorship.[11] Given the Enterprises' lack of market equity during the conservatorship, application of this recommended approach would necessarily depend on conservative assumptions about their cost of capital, until termination of the conservatorships permits taking account of actual market experience with those costs. For the remainder of the conservatorships, however, the Enterprises' increased flexibility to build capital through earnings since the 2021 modifications to the Preferred Stock Purchase Agreements[12] means that the approach would still maximize the cost-effectiveness of a combination of CRTs and common equity/retained earnings to stand between Enterprise risk and taxpayers.

Question 8: Will the proposed amendments to the CRT securitization framework provide the Enterprises with sufficient incentives to engage in more CRT transactions without compromising safety and soundness?

The proposed amendments, as written, are inadequate to promote the cost-effectiveness analysis ABA recommends. .

FHFA's proposal refers for example, on page 20, to Fannie Mae's reluctance to engage in additional single-family CRT. As FHFA notes in the relevant Fannie Mae 10-Q form:

[9] An appropriate, detailed development of this relative-value methodology is beyond the scope of this comment, but, conceptually, it could for example employ some variation of a "capital asset pricing model." Some of the necessary inputs would not depend on the Enterprises' exit from conservatorship, though others, perhaps such as theoretical Enterprise equity volatility, would have to be assumed prior to exit. Assessing the return on a Reference Pool without CRT protection against the risk-adjusted return net of CRT costs should provide a basis for judging whether equity is more financially efficient in absorbing loss than a given CRT structure at a given price.

[10] As acknowledged above, prior to conservatorship exit, the analysis must include proxy assumptions about the Enterprises' cost of equity.

[11] *See* 85 *Fed. Reg.* at 39,275 (June 30, 2020).

[12] *See* https://home.treasury.gov/news/press-releases/sm1236.

> The risk in force of these transactions, which refers to the maximum amount of losses that could be absorbed by credit risk transfer investors, was approximately $36 billion as of June 30, 2021 compared with $43 billion as of June 30, 2020. Because of the large number of mortgage prepayments in the past year, the first loss retention layer on our credit risk transfer transactions has increased as a percentage of the outstanding reference pool. As a result, losses on the remaining covered reference pools must generally reach a higher percentage of the remaining outstanding balance before those credit risk transfer transactions will pay any benefits. In addition, home price appreciation since we entered into the transactions has reduced the likelihood that we will incur losses on the covered loans large enough to receive a benefit from these transactions.[13]

Fannie Mae's logic here makes perfect sense, and the issue probably has little to do with risk-based capital weights. It is easy to imagine many CRTs that the Enterprises entered into, for example in 2015 through 2020 where the prepayments of the loans in the Reference Pools have been almost hyperbolic and the home price appreciation has been so high that, with the benefit of perfect hindsight, it may have been uneconomic to put these loans into a CRT vehicle. *This would be true, and was true before, even without the capital weights in the ECRF of December 2020.* There are periods of time where market factors mean that CRT transactions would not be cost-effective. The expected loss (EL) of the pool could have been (and was) less than the guarantee fee the Enterprise would have received absent the CRT, *with no UL*. An arbitrary target for CRTs related to certain parts of the Enterprises' portfolios may fail to optimize loss absorption and capital retention of the Enterprises. Undoubtedly in the future there will be times when interest rates rise, prepayments slow, and UL rises. Those may be better times to engage in CRT transactions. Anticipating such times and pricing the M1 pieces accordingly, along with a conservative comparison with the cost of equity as alternative loss absorption, is the crux of risk management. The end objective is not simply to see if people will buy CRT securities, but whether the transactions are effective at transforming and transferring risk in commercially reasonable terms.

Of course, an analysis based on experience and hindsight provides a better picture of what did happen than of what will happen. Perhaps FHFA should consider embedding mechanisms to permit the Enterprises to exit uneconomical CRTs. Call options built into the M1 securities could be a useful tool for FHFA to encourage.[14] Again, we urge FHFA to look for creative solutions to credit risk mitigation, not simply rely on standardized products and risk weights that apply in all cases. A more careful analysis of the relative benefits of different loss-absorption tools will both enhance taxpayer protections and improve the chances for an expeditious exit from conservatorship.

[13] Fannie Mae, Second Quarter 2021 Form 10-Q, page 39

[14] There are already the equivalent of "clean up calls" in most single-family CRTs, but the Enterprises would might have to consider calls that involve a premium paid to the bond holder, similar to calls in many corporate bonds, including Agency debt the Enterprises have long issued.

On page 25 of the proposal, FHFA discusses its rationale for revisiting the ECRF's CRT treatment and states, among other things:

> FHFA believes that part of the process to responsibly end the conservatorships of the Enterprises includes the transfer of a portion of the credit risk of the Enterprises to private markets.[15]

ABA fully agrees with FHFA on this point. As we noted earlier, we have not taken a position on the ultimate post-conservatorship form that the Enterprises should take, but we concur that one of the major goals of the conservatorship should be to continue to find ways to reduce the risks held by the Enterprises and the taxpayers who provide their backstop.

Part III, C Responses to Technical Corrections and Amendments
We support the correction to 1240.33 as supporting the original mathematical objective of the adjustment. We note no other issues regarding Part III.

Part IV, Section 1240.44

We have noted our objection to changing the term "10 percent" to "5 percent" as unsupportable and unsound. This would apply to "h." and "j." on page 52 of the proposal as well as the proposed amendment of "(d)" on page 53 of same, as well as the proposed amendment to "(h) on page 54 of same.

We have noted our opposition to removing the Overall Effectiveness Adjustment, which is there for sound prudential reasons. Thus, we cannot support the amendment to "p." on page 52 of the September, 2021, NPR, as well as the proposed amendment specified under "(f)" on page 53 of same.

> ***In conclusion, FHFA has the opportunity to promote the Enterprises' near-term safety and soundness, to improve their effective support roles in adverse market conditions, and to facilitate timely exits from conservatorship.***

ABA believes that the ultimate tool to transfer credit and other risks of the Enterprises is sale of common stock to private investors—but shareholders also press for returns, which eventually can lead to greater risk taking. While FHFA has made reforms to limit that potential risk taking, only legislation can make those reforms durable. Until these reforms are made permanent – and even after reform, nothing would do more to transfer risk away from the taxpayers and incentivize risk management than the Enterprises having a well-funded public equity capital base. Having too many CRT positions – which can ineffectively consume guarantee fee income – may in fact be an obstacle to new investors' prospective return on capital (ROE) requirements, and this is something the FHFA should keep in mind as it continues to chart a path out of conservatorship for the Enterprises.

[15] 86 *Fed. Reg.* at 53,236 (September 27, 2021).

FHFA has done a noteworthy job with the tools that it has and those developed by the Enterprises. Risk capital is only one tool for regulatory management. There comes a point, though, where new approaches to the use of risk transfer mechanisms for safety and soundness are needed. CRT, as it has been developed, is also only one tool, and certainly not the central component of risk management. We urge and encourage FHFA to pursue new and more expansive approaches, ultimately including private capital, than those narrowly considered in the proposal. The analysis recommended above for comparing relative costs of equity and CRT transactions in a given market environment should assist the Enterprises in striking an appropriate balance without impairing taxpayer protections prior to conservatorship exit, and should continue to promote an appropriate balance thereafter.

We appreciate the opportunity to provide comments and hope that these are useful as FHFA works to finalize the latest proposal. If you would like to discuss any of these issues in more detail, please contact Joseph Pigg, Senior Vice President and Senior Counsel, at JPigg@aba.com or the undersigned at HBenton@aba.com.

Sincerely,

/S/

Hu A. Benton
Senior Vice President and Policy Counsel