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November 23, 2021

Mr. Clinton Jones
General Counsel
Federal Housing Finance Agency
400 Seventh Street, SW
Washington, DC 20219

Attention: Comments/ RIN 2590–AB17, Enterprise Regulatory Capital Framework Rule—Prescribed Leverage Buffer Amount and Credit Risk Transfer

Dear Mr. Jones:

The Housing Policy Council ("HPC")[1] appreciates the opportunity to submit this comment letter in response to the Federal Housing Finance Agency's ("FHFA") Notice of Proposed Rulemaking (the "NPR") on the Enterprise Regulatory Capital Framework (the "ERCF") for Fannie Mae and Freddie Mac (the "Enterprises").[2]

HPC Supports the Proposed Changes to the ERCF

In the NPR, FHFA has proposed three modifications to the ERCF. Specifically, FHFA is proposing to: (1) replace the fixed prescribed leverage buffer amount ("PLBA") with a dynamic buffer equal to 50 percent of an Enterprise's stability capital buffer; (2) reduce the prudential floor on the risk weight assigned to any retained credit risk transfer ("CRT") exposures from 10 percent to 5 percent; and (3) remove the overall effectiveness adjustment on CRT exposures. **HPC appreciates FHFA's reconsideration of these provisions in the ERCF and supports each of the proposed changes.**

A Dynamic PLBA Reinforces the Risk-Based Focus of the ERCF

The PLBA, combined with the base leverage requirement, was intended to serve as a credible backstop to the risk-based capital requirements in the ERCF. Yet, an excessively high leverage capital requirement would become the binding capital requirement for the Enterprises, and, as FHFA has acknowledged, a binding leverage requirement creates an incentive for an Enterprise to increase risk because additional risk is not reflected in commensurately higher

[1] HPC is a trade association compromised of the nation's leading mortgage lenders, servicers, mortgage insurers, and title and data companies. HPC advocates for the mortgage and housing finance interests of its members in legislative, regulatory, and judicial forums. Our interest is in the safety and soundness of the housing finance system, the equitable and consistent regulatory treatment of all market participants, and the promoting of lending practices that create sustainable home ownership opportunities leading to long-term wealth-building and community-building for families.
[2] 86 Fed. Reg. 53230 (Sept. 27, 2021).

capital requirements.[3] A binding leverage requirement also is a disincentive for CRT transactions since the Enterprises lose any capital benefit from CRT. Replacing the fixed leverage buffer with a better calibrated, dynamic buffer reduces the potential for the leverage capital requirement to be the binding capital requirement for the Enterprises and reinforces the risk-based focus of the ERCF.

The Proposed Changes to CRT Exposures Would Make CRT Transactions More Economic

As we noted in our 2020 comment letter to FHFA on the ERCF (the "2020 Comment Letter"), the treatment of CRT exposures is one of the "most critical elements" of the ERCF.[4] CRT transactions lessen the systemic risk posed by the Enterprises by reducing the concentration of that risk on the Enterprises' balance sheets and the volatility inherent in the credit performance of the Enterprises' guarantee business. CRT does this by introducing a range of other active participants with an economic stake in monitoring mortgage market credit conditions to contain risk. These added participants mitigate potential risk-assessment and risk-management errors by the Enterprises. Also, introducing other deeply subordinated investment classes in mortgage credit risk beyond just Enterprise equity instruments, broadens the array of market signals regarding mortgage credit risk. FHFA's proposed changes affecting CRT transactions would make CRT transactions somewhat more economic. This would expand the risk-reducing and competitive benefits of CRT transactions.

HPC Recommends Additional Changes to the ERCF to Achieve FHFA's Goals

In the NPR, FHFA describes the modifications to the ERCF as "better reflect[ing] the risks inherent in the Enterprises' business models and encourage[ing] the Enterprises to distribute acquired credit risk to private investors rather than to buy and hold that risk."[5] FHFA also poses several questions in the NPR that invite comment on other changes to the ERCF to further accomplish these goals. Specifically, FHFA asks whether the prudential risk weight floor of 20 percent on single-family exposures is appropriately calibrated in light of the changes proposed in the NPR, and whether 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.

HPC welcomes the invitation to recommend other changes to the ERCF. In the attached Appendix, we list several additional changes that would further enhance the risk-based focus of the ERCF and the economics of CRT transactions to provide the appropriate incentives for risk sharing by the Enterprises. Most notably, we reiterate our recommendation that FHFA use risk-weighted assets, not adjusted total assets, in calculating the PCCBA buffers. We believe that our proposed additional changes to the ERCF would materially improve the effectiveness of the

[3] 86 Fed. Reg. 53231 (Sept. 27, 2021).
[4] Letter to Mr. Alfred M. Pollard, General Counsel Federal Housing Finance Agency, from Edward J. DeMarco, President, Housing Policy Council, August 31, 2020, p. 11.
[5] 86 Fed. Reg. 53230 (Sept. 27, 2021).

ERCF while reinforcing the ability of the Enterprises to support the secondary mortgage market across economic cycles, including periods of financial stress.[6]

We would be pleased to discuss these comments in further detail, and if you have any questions about the additional changes described in the Appendix, please contact me at 202-589-1923.

Yours truly,

Edward J. DeMarco
President
Housing Policy Council

[6] We encourage FHFA to review HPC's 2020 Comment Letter, which contains additional analysis supporting the recommendations in the Appendix.

APPENDIX

HPC's Recommendations to Further Enhance the Enterprise Regulatory Capital Framework and Increase Private Capital Risk-Sharing

This Appendix describes additional changes to the Enterprise Regulatory Capital Framework (the "ERCF") that the Housing Policy Council ("HPC") believes would improve the ERCF and encourage private capital risk-sharing, while continuing to promote strong capital levels to backstop the risk assumed by the Enterprises. The revisions to the prescribed leverage buffer amount (the "PLBA") and to the treatment of credit risk transfer ("CRT") exposures proposed by the Federal Housing Finance Agency ("FHFA") in the Notice of Proposed Rulemaking (the "NPR") represent a meaningful improvement to that framework. Yet, we believe additional changes to the ERCF would create a more risk-sensitive structure that further encourages the distribution, rather than accumulation by the Enterprises, of mortgage credit risk in the financial system. The changes to CRT proposed by FHFA, while welcome, fall short of recognizing the full extent of the risk-distributing benefits of CRT to the Enterprises and CRT's contribution to the stability and robustness of the mortgage finance system. To further enhance the risk-sensitivity of the capital framework, FHFA also should modify certain other provisions in the ERCF.

We recommend three primary adjustments, including two we suggested in our comment letter to FHFA on the ERCF last year (the "2020 Comment Letter"). First, the capital buffers included in the risk-based capital requirements (collectively, the PCCBA) should be calibrated using risk-weighted assets rather than adjusted total assets. Second, the minimum tranche risk weight floor on retained CRT exposures should be reduced below 5 percent, using a sliding scale based on the distance of the CRT detachment point relative to stressed losses on the underlying mortgage pool. Third, the single-family credit risk-weight floor should revert to the originally proposed 15 percent from 20 percent on lower risk exposures. When combined, we believe these three adjustments will make the risk-based capital requirements imposed by the ERCF more responsive to the underlying credit risks, encourage risk distribution, and ensure an appropriate amount of capital is held by the Enterprises.

Of the changes recommended in this Appendix, the most important is to revise the capital buffers so that they are calibrated based on risk-weighted assets rather than adjusted total assets. This change will ensure an appropriate level of risk sensitivity in the ERCF. Absent this important change, the risk-based capital requirement is, in effect, a hybrid measure that is the sum of a risk-based capital requirement and a relatively invariant leverage ratio. Embedding a leverage ratio within the risk-based measure is a duplicative, and counterproductive, requirement. The ERCF includes a separate leverage ratio and calibrating the capital buffers on adjusted total assets makes the risk-based requirement much less responsive than it should be to changes in the actual credit risk assumed by the Enterprises. The current PCCBA calibration also diminishes the effectiveness of CRT and blunts the economic incentives to execute risk sharing, which is inconsistent with FHFA's highly desirable objective of encouraging more CRT.

Background and Context: Clarifying the Objectives of Proposed Recommendations

Before describing our proposed additional changes to the ERCF, we thought it would be useful to explain the rationale for the proposed changes.

First, as noted in our 2020 Comment Letter, CRT accomplishes several important public policy objectives: CRT attracts a broad set of investors that analyze and price the mortgage credit risk held by the Enterprises and that assume some of that risk using their own capital; CRT reveals actual market pricing for the mortgage credit risk held by the Enterprises, which provides highly useful information during periods of both market strength and weakness; CRT balances the mix of capital held by the Enterprises between common equity, other subordinate capital, and CRT to promote the effective deployment of capital, maximizing pricing efficiency and benefiting home buyers by lowering mortgage rates; CRT substantially reduces the concentration of mortgage credit risk on the Enterprises' balance sheets and thereby reduces systemic risk; CRT reduces the amount of capital the Enterprises need to support their guarantee business; and CRT reduces the exposure of taxpayers to the Enterprises. Therefore, we believe that the ERCF should ensure that the implied cost of capital for issuing CRT is competitive with other primary capital alternatives, especially common equity.

If, for example, it costs an Enterprise 11 percent after tax to raise a dollar of equity capital to cover mortgage credit risk, then the implied cost of capital relief under the ERCF for raising a dollar of CRT protection should be firmly under 11 percent (based on the average cost over the expected life of the transaction). Otherwise, the Enterprises will lack a true economic incentive to issue CRT, with the unintended consequence of increasing systemic risk by concentrating most mortgage credit risk and risk assessment functions at the two Enterprises.

Another result when CRT is not competitive with other forms of capital will be higher mortgage rates for consumers arising from an inefficient deployment of mortgage credit risk capital across the financial system. CRT only covers mortgage credit risk for a specified mortgage pool, whereas common equity and other forms of capital cover all the risks the Enterprise faces, in addition to mortgage credit risk. If the cost of CRT capital is not clearly below the cost of equity, then management of an Enterprise has little economic incentive to shed the risk. As shown in the examples below, even with the adjustments to the ERCF proposed in the NPR, the cost of CRT capital is not materially less than equity capital and, in some cases, may even be greater than the cost of equity capital.

Second, we appreciate that the amount of capital relief from CRT should not be unlimited. HPC agrees with FHFA that a dollar of credit protection from CRT is not equivalent to a dollar of protection from equity and that CRT capital relief should be less than 100 percent. However, the amount of capital relief provided by CRT in many cases is less than half the economic loss protection purchased. While 100 percent capital relief is too high, 40 percent is too little when the Enterprises are selling virtually all of the risk of unexpected credit losses to third parties, often in amounts that substantially exceed estimated stressed losses.

Third, we also appreciate the challenge FHFA faces in ensuring sufficient capital for low-risk loans without imposing a capital charge that drives such loans away from the Enterprises

and causes the Enterprises to increase purchases of riskier loans. However, there is a vast difference in credit risk across the spectrum of individual single-family mortgages backed by the Enterprises. We estimate that more than half of all currently guaranteed Enterprise loans, and perhaps as much as 70 percent, are low-risk loans subject to the 20 percent risk-weight floor. Thus, an unintended consequence of the 20 percent risk-weight floor is that the majority of the single-family mortgage loans held by the Enterprises are not subject to a risk-sensitive capital framework.

Finally, the ERCF should be appropriately risk sensitive. The ERCF seeks to build a fine-tuned, quantitatively rigorous risk-based capital framework based upon a rich history of Enterprise credit performance. Overlaying the framework with large, risk-insensitive, capital buffers, combined with a loan level risk floor that is set too high, defeats the purpose of creating a risk-based framework, possibly leading to unforeseen adverse consequences and market distortions. The result will be an inefficient allocation of capital and distribution of risk, which drives up mortgage rates without a meaningful reduction in risk for the Enterprises, the financial system, or taxpayers.

Recommendation: The Risk-Based Capital Buffers Should be Calibrated using Risk-Weighted Assets Rather than Adjusted Total Assets

In connection with the proposed revision to the prudential floor for retained CRT exposures, we recommend that FHFA calibrate the Enterprise risk-based capital buffers using risk-weighted assets rather than adjusted total assets. We made this recommendation in our 2020 Comment Letter, with Appendix C providing a detailed analysis of our rationale for switching to more risk-sensitive buffers for risk-based capital.

In the preamble to the final 2020 ERCF, FHFA acknowledged that using adjusted total assets in the capital buffers rather than risk-weighted assets was a "notable" departure from the Basel framework.[1] Nonetheless, FHFA concluded that using adjusted total assets was necessary to reduce the impact that the buffers could have on higher risk exposures, avoid amplifying the secondary effects of any model or similar risks inherent to the calibration of the risk weights for mortgage exposures, and mitigate the pro-cyclicality of the risk-based capital requirements.

This departure from the Basel framework will have unintended consequences. Using adjusted total assets in the risk-based buffers results in a large amount of relatively fixed capital requirements per dollar of mortgage exposure, irrespective of the risk of the asset for which capital is held. One consequence is that too much capital will be required for very low-risk loans, thereby incentivizing the Enterprises to reduce their exposure to such loans since the return on equity would be inadequate. This will incent the Enterprises to increase their exposure to higher risk loans, since such loans would be more likely to meet or exceed the cost of equity. HPC appreciates FHFA's concern that using risk-weighted assets would widen the difference between capital required on low-risk loans compared to high-risk loans. Yet, the economic realities of these differences in risk are present regardless of whether they are recognized in the ERCF. Furthermore, the Enterprises have generally used CRT to manage capital requirements and overall exposure to the higher risk loans they guarantee, including 30-year mortgages with

[1] 85 Fed. Reg. 82164 (Dec. 17, 2020).

loan-to-value ratios in excess of 60 percent. By implicitly not adjusting for these real differences in risk in setting minimum risk-based capital requirements, the ERCF creates unintended consequences in capital allocation and in where and how mortgages are financed in the system.

These unintended consequences are exacerbated by combining a 20 percent risk weight floor on single-family mortgages with the risk-insensitive capital buffers. This combination produces a substantial capital charge on low-risk mortgages (e.g., loans with less than 60 percent loan-to-value ratios and high consumer credit scores). These mortgage loans have negligible default risk and low loss given default. Also, they currently represent a meaningful share of the Enterprises' portfolios. A 20 percent risk weight floor not only distorts market signals about risk, but it also incentivizes more risk taking by the Enterprises (as higher risk loans with higher guaranty fee loans would have to offset the unnecessarily high capital requirements on lower risk loans).

To better illustrate the impact of the issues discussed above, as well as our recommended changes, Tables 1-3 show some calculations using the Enterprise Regulatory Capital Framework CRT Tool created by FHFA. Our calculations are based on the examples pre-loaded into the Excel tool, with modifications corresponding to varying inputs. Importantly, we show pool-level credit risk capital requirements holistically, rather than using the more simplistic 8 percent of risk-weighted asset capital assumption shown in the tool. Because risk-based capital requirements under the ERCF are the sum of 8 percent of risk-weighted assets *plus* the separately calibrated capital buffers, which are not impacted by CRT issuance, the capital buffers must be incorporated into any complete impact analysis of the capital framework.

Table 1 provides an example of estimated capital requirements pre- and post-CRT issuance. Required capital is based on the sum of 8 percent base capital, required buffers, and an assumed modest management buffer of 1 percent.[2] For our calculations, we assume a reasonable cost of capital for each part of the subordinated capital stack, and we use a through-the-cycle pretax cost of CRT of 4 percent, which is consistent with Fannie's pre-COVID all-in cost of CRT estimated from operating segment financial statements.

[2] We believe prudent management always would operate with a buffer to avoid triggering any potential capital conservation actions.

Table 1
Example of Capital Relief and Cost of Capital Calculations for Representative CRT Transaction

	Base	2020 ECRF 10% floor	2021 ECRF 10% floor	2021 ECRF 5% floor	2021 ECRF 2.5% floor	2021 ECRF 0% floor
UPB	1,000,000,000	1,000,000,000	1,000,000,000	1,000,000,000	1,000,000,000	1,000,000,000
Cost of CRT (pretax)	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Cost of common equity (after tax)	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%
Cost of subordinated debt (after tax)	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Cost of preferred equity (after tax)	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
Tax rate	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%
Freddie HQA (as stated in ECRF CRT Tool, 0.50% attach, 4.50% detach, 2.75% base capital requirement)						
RWAs	418,750,000	243,928,556	230,249,237	182,427,183	158,516,157	134,606,086
CRT balance	38,000,000	38,000,000	38,000,000	38,000,000	38,000,000	38,000,000
Base CET1 RBC (4.5% RWAs)	18,843,750	10,976,785	10,361,216	8,209,223	7,133,227	6,057,274
Freddie PCCBA (1.5% UPB)	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000
CET1 management buffer (1.0% RWAs)	4,187,500	2,439,286	2,302,492	1,824,272	1,585,162	1,346,061
Total CET1	38,031,250	28,416,071	27,663,708	25,033,495	23,718,389	22,403,335
Preferred capital (1.5% RWAs)	6,281,250	3,658,928	3,453,739	2,736,408	2,377,742	2,019,091
Subordinated debt (2.0% RWAs)	8,375,000	4,878,571	4,604,985	3,648,544	3,170,323	2,692,122
Total capital	52,687,500	36,953,570	35,722,431	31,418,447	29,266,454	27,114,548
Total capital % loan UPB	5.27%	3.70%	3.57%	3.14%	2.93%	2.71%
% reduction RWAs		*-41.7%*	*-45.0%*	*-56.4%*	*-62.1%*	*-67.9%*
% reduction CET1		*-25.3%*	*-27.3%*	*-34.2%*	*-37.6%*	*-41.1%*
% reduction capital		*-29.9%*	*-32.2%*	*-40.4%*	*-44.5%*	*-48.5%*
Implied cost of CRT total capital relief		*7.6%*	*7.1%*	*5.6%*	*5.1%*	*4.7%*
Implied cost of total capital (hurdle)		*9.4%*	*9.5%*	*9.6%*	*9.7%*	*9.8%*
Implied cost of CET1 relief*		***13.1%***	***11.9%***	***9.0%***	***7.9%***	***7.0%***
Implied cost CET1 minus 11% COE		*2.1%*	*0.9%*	*-2.0%*	*-3.1%*	*-4.0%*

Table 2 illustrates the impact on Enterprise capital requirements from CRT issuance under the NPR. Using the CRT Tool, the table shows total capital requirements, implied cost of CET1 relief due to CRT, and total capital relief. We apply the proposed 5 percent prudential floor (reduced from 10 percent in the 2020 rule) for retained CRT tranches. As illustrated in the table, even under the NPR, the imputed cost of CRT capital relief is still quite high and in some cases is actually higher than the cost of common equity.

Table 3 shows the same calculations as in Table 2 but incorporates our recommended formulation of the capital buffers based on risk-weighted assets rather than adjusted total assets. We still assume CRT is subject to the proposed 5 percent prudential floor on retained tranches. Comparing Table 2 and Table 3 indicates that using risk-weighted assets for the capital buffers results in more meaningful overall capital relief using CRT, about 55 to 70 percent relief compared to only 40 percent under the NPR, for each dollar of credit loss absorption purchased. This improves the economic incentives for using CRT transactions and thereby increases the likelihood that the Enterprises will use CRT for risk management. Lowering the imputed cost of CRT capital improves the economics facing the Enterprises, allows for lower guarantee fees for the same targeted return on common equity, and materially reduces risk exposure retained on Enterprise balance sheets.

Table 2
Impact of CRT with 5 Percent Tranche Floor and Capital Buffers Based on Adjusted Total Assets (ERCF as Proposed)[3]

	Total Capital (% UPB)	Implied After-Tax Cost of CET1 Relief	Total Capital Relief (% of Base Capital)
Freddie HQA (as stated	3.14%	9.0%	-40.4%
Freddie DNA (as stated)	2.43%	11.3%	-42.2%
Freddie HQA (95% capital markets)	3.03%	8.4%	-42.5%
Freddie DNA (95% capital markets)	2.39%	11.0%	-43.2%
Fannie CAS (as stated)	3.36%	8.5%	-39.7%
Fannie CIRT (as stated)	2.70%	10.0%	-40.0%
HYPOTHETICAL 20% RW Fre DNA	2.22%	13.1%	-32.8%

Table 3
Proposed Rule with 5 Percent Tranche Floor and Alternative Capital Buffers Based on Risk-Weighted Assets (HPC Proposed Adjustment to ERCF)[4]

	Total Capital (% UPB)	Implied After-Tax Cost of CET1 Relief	Total Capital Relief (% of Base Capital)
Freddie HQA (as stated	2.33%	5.5%	-55.9%
Freddie DNA (as stated)	1.32%	5.6%	-68.7%
Freddie HQA (95% capital markets)	2.16%	5.1%	-58.9%
Freddie DNA (95% capital markets)	1.25%	5.4%	-70.1%
Fannie CAS (as stated)	2.34%	4.9%	-58.0%
Fannie CIRT (as stated)	1.35%	4.5%	-70.0%
HYPOTHETICAL 20% RW Fre DNA	1.07%	4.1%	-70.2%

Using risk-weighted assets rather than adjusted total assets to calibrate the buffers has the biggest impact on the economics of CRT for low-risk loans. As shown in the last row of Tables 2 and 3, the change in the cost of capital relief is much greater on low-risk loans using risk-weighted assets rather than adjusted total assets for the buffer. Moreover, if FHFA is concerned

[3] Calculations are derived directly from FHFA's Enterprise CRT Tool by applying inputs to the specific CRT example transactions pre-loaded in the spreadsheet.
[4] We assume a PCCBA of 4.50 percent for Fannie Mae and 3.75 percent for Freddie Mac, based roughly on requirements for the largest domestic SIFIs

about climate change and other non-traditional credit risks, it may make sense to encourage the Enterprises to buy protection on lower LTV loans.

The ERCF's use of buffers based on adjusted total assets also is not conceptually consistent with a robust risk-based rule. The risks that FHFA seeks to mitigate by tying the capital buffers to adjusted total assets rather than risk-weighted assets are captured elsewhere in the ERCF. Specifically, the leverage requirement captures residual model risks not reflected in the risk-based requirements. Additionally, FHFA has incorporated other features in the ERCF aimed at reducing the potential pro-cyclical dynamics of the risk-based capital framework of the ERCF, and FHFA has discretion to increase the countercyclical capital buffer above zero. We believe having a large, quasi-fixed component of capital requirements as part of a risk-based framework, as is the case with the current ERCF, distorts decision making. We believe that a fixed capital buffer would only be appropriate if FHFA were to adopt something akin to the annual stress capital buffer developed by the Federal Reserve Board, which is both dynamic and responsive to actual changes in balance sheet risk over time. In the absence of a significant departure in the definition of risk-based capital under the current ERCF, making targeted adjustments so that the ERCF more closely resembles a fully risk-based framework is appropriate and desirable.

We recognize that if the capital buffers are based upon risk-weighted assets, the minimum capital multiplier applied to size the PCCBA would need to be recalibrated from current levels since risk-weighted assets are, on average, roughly one-third the size of adjusted total assets. (For instance, 15 basis points of risk-weighted assets would today produce about the same dollar amount of PCCBA buffer requirements as 5 basis points of adjusted total assets.) Making this modest adjustment would be a minor additional step which would make the Enterprises' capital requirements much more attuned to increases (and decreases) in risk.[5]

Finally, we note that the pro forma risk-based capital levels for the Enterprises using the current version of the ERCF remain far in excess of the capital needed to survive any sort of stressed environment as going concerns. For example, as shown in Table 4, using 2021 DFAST results, Fannie Mae would have capital equal to nearly 25 times its projected 9-quarter stressed losses, while Freddie Mac would have capital over 33 times stressed losses. This result speaks to the benefits of CRT risk sharing, the high quality of the underlying credit books, and the conservative design of the ERCF. Even with our proposed adjustments to the ERCF, the Enterprises would remain extremely well capitalized by any objective standard.

[5] Another recalibration for FHFA to consider is the multiplier applied to third-party originations in the calculation of risk weighted assets. FHFA should consider whether this adjustment is warranted based on risk – we suspect it is not – and whether it adversely affects (1) loan originators that do not want to retain servicing, and (2) the loan aggregators that provide an added layer of credit protection for the Enterprises while enabling such originators to remain competitive in the primary market.

Table 4
Actual Capital Requirements Under ERCF/CCF Compared to DFAST Severely Adverse Results

FHFA Annual DFAST Severely Adverse Scenario Results for GSEs vs. Capital Requirements						
	Fannie Mae			Freddie Mac		
$ billions	2019 DFAST[1]	2020 DFAST[2]	2021 DFAST[3]	2019 DFAST[1]	2020 DFAST[2]	2021 DFAST[3]
Pretax, preprovision income	17.4	24.2	37.6	13.4	17.3	19.7
Provision for credit losses	(26.0)	(22.5)	(24.7)	(16.5)	(19.4)	(16.8)
Mark to market gains/(losses)	(0.4)	0.7	(0.0)	(2.1)	(1.3)	5.3
Trading and counterparty losses	(2.9)	(2.3)	(2.6)	(3.5)	(4.0)	(3.6)
Pretax income	(11.9)	0.1	10.2	(8.8)	(7.5)	4.6
Income taxes	2.6	(0.0)	(2.0)	1.8	1.6	(1.0)
Other comprehensive income	(0.3)	(0.0)	(0.0)	(1.5)	(1.2)	(0.9)
Total comprehensive income	**(9.6)**	**0.0**	**8.1**	**(8.4)**	**(7.1)**	**2.7**
Valuation allowance deferred tax assets	(19.2)	(14.5)	(15.7)	(8.7)	(7.5)	(6.1)
Total comprehensive income, with DTA	**(28.8)**	**(14.5)**	**(7.5)**	**(17.2)**	**(14.6)**	**(3.4)**
Total capital under ECRF/CCF around DFAST	85.8	171.4	186.0	51.1	112.0	114.0
CET1 under ECRF/CCF around DFAST	85.8	127.3	138.1	51.1	79.9	85.1
Total capital as % comprehensive income	894%	nm	nm	605%	1582%	nm
CET1 as % comprehensive income	894%	nm	nm	605%	1128%	nm
Capital as % comprehensive income w/ DTA	298%	1184%	2477%	297%	768%	3353%
CET1 as % comprehensive income w/ DTA	298%	879%	1839%	297%	548%	2501%
Average assets (estimated)	3,411.8	3,558.8	4,000.0	2,093.8	2,109.8	2,558.4

1. Based on required capital at 9/30/2019 under 2018 CCF
2. Based on required capital at 6/30/2020 under 2020 final ERCF
3. Based on required capital at 3/31/2021 under 2021 proposed ERCF

Recommendation: Eliminate or Modify the Prudential Floor for CRT Exposures

Question 5 in the NPR asks if "the 5 percent prudential floor on the risk weight for a retained CRT exposure [is] appropriately calibrated?"[6] As described in the cover letter to this Appendix, HPC views FHFA's proposed reduction of this floor from 10 percent to 5 percent as a step in the right direction.

However, in our 2020 Comment Letter, we wrote that: "We specifically recommend that the 10 percent risk-weight floor be eliminated. At the very least, the floor should be adjusted on a sliding scale, as higher detachment points on the sold risk means the risk of loss on retained tranches becomes ever more remote."[7] This remains our view.

Eliminating the prudential floor for CRT transactions would moderately reduce the implied cost of capital for CRT protection while encouraging its expanded use. Table 5 illustrates that a 0 percent tranche risk weight floor would make CRT transactions even more attractive compared to common equity, while leaving the Enterprises holding sufficient capital to address unanticipated changes in economic conditions. Table 6 further illustrates the impact of a 0 percent tranche floor combined with our proposal that the risk-based capital buffers be calibrated using risk-weighted assets, as discussed above. Because the Enterprises still retain

[6] 86 Fed. Reg. 53239 (Sept. 27, 2021).
[7] 2020 Comment Letter, p. 19.

first loss risk on the underlying mortgage pool, and also have Dodd-Frank risk retention requirements, even with a 0 percent tranche floor there is never going to be full capital relief.

Table 5
Impact of CRT with 0 Percent Tranche Floor and Capital Buffers Based on Adjusted Total Assets

	Total Capital (% UPB)	Implied Cost of CET1 Relief	Total Capital Relief (% of Base Capital)
Freddie HQA (as stated)	2.71%	7.0%	-48.5%
Freddie DNA (as stated)	2.00%	8.6%	-52.4%
Freddie HQA (95% capital markets)	2.60%	6.6%	-50.7%
Freddie DHA (95% capital markets)	1.96%	8.4%	-53.4%
Fannie CAS (as stated)	2.93%	6.7%	-47.4%
Fannie CIRT (as stated)	2.27%	7.5%	-49.6%

Table 6
Impact of CRT with 0 Percent Tranche Floor and Capital Buffers Based on Risk-Weighted Assets

	Total Capital (% UPB)	Implied Cost of CET1 Relief	Total Capital Relief (% of Base Capital)
Freddie HQA (as stated)	1.72%	4.3%	-67.4%
Freddie DNA (as stated)	1.00%	4.9%	-76.2%
Freddie HQA (95% capital markets)	1.60%	4.1%	-69.6%
Freddie DHA (95% capital markets)	0.96%	4.8%	-77.1%
Fannie CAS (as stated)	1.69%	3.8%	-69.6%
Fannie CIRT (as stated)	1.03%	4.0%	-77.1%

HPC fully appreciates FHFA's reasons for establishing a floor and recognizes the challenges in calibrating the floor. FHFA has stated that "an Enterprise does retain some credit risk on its CRT and that the risk should be appropriately capitalized."[8] That is, even assuming the transfer of credit risk on a pool of loans provides protection for losses under highly stressed conditions, there remains a remote chance that actual losses on that pool exceed the CRT's modeled stress loss coverage. In addition, we understand that CRT capital is not fungible across

[8]86 Fed. Reg. 53439 (Sept. 27, 2021).

CRT deals and there may be some model risk in estimating stress losses. In consideration of these concerns, and if FHFA is not prepared to fully eliminate the floor, we encourage FHFA to consider changes to the prudential floor. Specifically, we recommend a sliding scale approach that phases out the floor based on exactly how remote the senior risk is that has been retained by an Enterprise on a mortgage pool. As noted above, we made this recommendation in our 2020 Comment Letter last year.[9]

We are concerned that with the proposed 5 percent tranche floor, there may be virtually no economic incentive for the Enterprises to engage in a CRT transaction that would have a detachment point above stress losses since there is no additional capital relief,[10] which would leave the Enterprises retaining that tail risk. Yet, because that risk of loss in the tails is so remote, in most environments it should also be relatively inexpensive to purchase protection for that remote outcome. We believe buying protection against catastrophic risk is in the interest of the Enterprises and their stakeholders, and it should be explicitly reflected in the treatment of CRT under the ERCF. By reducing the size of the prudential floor as risk is sold above projected stress loss levels, the ERCF could further incentivize the Enterprises to issue CRT transactions with high enough detachment points to mitigate any lingering concerns about potential model risk.

Extending CRT coverage in this way also would address FHFA's concerns regarding CRT fungibility with equity. Increasing capital relief for CRT and lowering the cost of CRT capital covering tail risk would encourage more effective risk transfer and produce a more efficient allocation of capital in the mortgage finance system. Such a sliding scale would require further calibration by FHFA and the Enterprises, but one potential approach is to base the scale on the total amount of CRT coverage as a multiple of projected stressed losses on the underlying mortgage pool (i.e., as the multiple of modeled losses goes up, the floor would go down).

Finally, we note that current CRT structures indicate that there should not be safety and soundness concerns from using a lower prudential tranche floor. As an example, we analyzed a recent new issue Freddie Mac high-LTV CRT deal, STACR 2021-HQA3. Credit losses that would occur in a repeat of the housing crash during the Global Financial Crisis were estimated using an HPC member's model. As shown in Table 7, under the NPR, the amount of risk capital required to be held against the retained risk from this type of CRT deal is over 9 times stressed losses. This supports our view that setting the minimum tranche floor at 0 percent, assuming an Enterprise has purchased deep enough CRT coverage, when combined with using truly risk-based capital buffers, would still leave sufficient capital available to cover residual credit risk retained by the Enterprises after executing CRT.

[9] 2020 Comment Letter, p. 19.

[10] Updating the example used on page 18 in our 2020 Comment Letter, a $1 billion CRT pool with expected base losses of merely $2.5 million (or 0.25%) and risk transfer on up to 4.5 percent of the pool's UPB (equivalent to 18 times expected losses) would still require the Enterprise to hold 8 percent capital against 5 percent of the 95.5 percent retained senior UPB.

Table 7
Illustration of Losses and Capital Redundancy for Actual CRT Transaction

STACR 2021-HQA3 Illustration	% UPB
Original subordination through M1 tranche	3.25%
Total projected deal writedowns in GFC replay	1.55%
Freddie deal losses in GFC replay	0.32%
Freddie share of total deal losses	20.7%
Risk-based capital from CRT Tool for HQA deal*	3.03%
Capital coverage of Freddie GFC deal losses (%)	945.4%
HPC adjusted capital from CRT Tool for HQA deal**	1.55%
HPC adjusted capital coverage of Freddie GFC deal losses (%)	483.6%

** Assumes 95% capital markets execution, 5% retention*
*** Buffers using RWAs and sliding 0% CRT tranche floor, per HPC proposals*

In summary, by further reducing (haircutting) the prudential floor for CRT sold in excess of modeled stress losses, FHFA would create a greater economic incentive for the Enterprises to transfer more risk. This would align the capital rules with the estimated low nominal cost of that extreme tail protection in most market environments, and improve the resiliency of the Enterprises.

Recommendation: Reduce the Risk Weight Floor for Single-Family Mortgages from 20 Percent to 15 Percent

In Question 4, FHFA asks if the prudential risk weight floor of 20 percent on single-family mortgages is appropriately calibrated given the proposed amendments to the capital framework related to the PLBA and CRT. We recommend that FHFA reduce the floor to 15 percent.

When FHFA originally proposed the minimum floor, it set the level at 15 percent. In doing so, FHFA stated that the 15 percent floor would have been sufficient to absorb the cumulative losses incurred in the single-family books of the Enterprises during the financial crisis.[11] Despite this earlier analysis, FHFA increased the minimum floor to 20 percent in the final rule.

FHFA offered four reasons for increasing the minimum floor from 15 percent to 20 percent: (1) the gap between the proposed rule's risk weights for lower risk single-family

[11] 85 Fed. Reg. 39319 (June 30, 2020). ("Absent the 15 percent risk weight floor, Freddie Mac's estimated single-family credit risk capital requirement of $61 billion as of December 31, 2007 under the proposed rule would have been less than its crisis-era single-family cumulative capital losses. *With the addition of the 15 percent risk weight floor, Freddie Mac's estimated single-family credit risk capital requirement would have exceeded its crisis-era single-family cumulative capital losses.* Absent the 15 percent risk weight floor, Fannie Mae's estimated single-family credit risk capital requirement would have exceeded its crisis-era single-family cumulative capital losses, but by a relatively small amount. *The addition of the 15 percent risk weight floor would have added approximately $8 billion to Fannie Mae's single-family credit risk capital requirement, clearing cumulative capital losses by a more comfortable margin.*") Emphasis added.

mortgage exposures and the risk weights for analogous exposures under the Basel and U.S. banking frameworks; (2) possible flaws in FHFA's method for calibrating the risk-based capital requirements, particularly given the concerns of some commenters that the leverage ratio would become the binding capital requirement for the Enterprises despite FHFA's intention that it be a backstop; (3) concerns that the portfolio invariant calibration of the credit risk capital requirements for mortgage exposures might not adequately take into account that each Enterprise's mortgage-focused business does not permit a diversified portfolio; and (4) the potential for the Enterprises to have a competitive advantage over some other sources of mortgage credit, which would heighten the risk to the competitiveness, efficiency, and resiliency of the national housing finance markets.[12]

We do not believe that these reasons justify the change. As FHFA has acknowledged, there are differences in the business models, statutory mandates, and risk profiles of the Enterprises compared to traditional banking organizations. Thus, while we agree that FHFA should look to the Basel banking rules as a guide for what is appropriate for the Enterprises, the capital rules for the Enterprises should be calibrated differently when there are noteworthy differences between the operations of the Enterprises and banking organizations. Additionally, while FHFA's prior calibration of the leverage ratio was flawed, that miscalculation does not mean that FHFA's analysis of the impact of the minimum risk weight floor was inaccurate, nor have we have seen any evidence to indicate that it was inaccurate. Furthermore, the capital buffers are designed to address additional risks incurred by the Enterprises, including the portfolio mix of the Enterprises' books.

Similar to the distortions created by the current PCCBA formulation, the 20 percent floor reduces the risk-based focus of the ERCF. Our analysis indicates that well over half of the single-family guaranty books of the Enterprises would be subject to the 20 percent floor as of June 30, 2021.[13] As a result, the floor effectively short-circuits the detailed risk-based analysis that FHFA has built into the single-family capital grids that are included in the ERCF. When combined with the current requirement that the capital buffers are to be based on adjusted total assets, less than one-fourth of single-family risk-based capital would actually vary with the changes in credit risk composition.

Furthermore, empirically the 20 percent minimum is overly conservative relative to the risk of the loans subjected to the floor. Table 8 shows modeled expected lifetime losses on newly acquired 30-year, low-risk loans (low LTV/high FICO loans) acquired by Fannie Mae in the first quarter of 2021. Table 9 shows stressed losses for the same group of loans, using an economic scenario somewhat worse than the DFAST severely adverse scenario. Finally, Table 10 shows total capital requirements for any newly originated loan subject to either a 15 percent or a 20 percent risk weight floor, including the impact of all capital buffers. As shown in Table 8, stressed losses for all of the 30-year loan categories subject to a 20 percent risk weight floor are materially below the corresponding required capital levels. Indeed, even with a 15 percent floor, capital requirements are comfortably above stressed losses for any loan category in the 15

[12] 85 Fed. Reg. 82172 (Dec. 17, 2020).

[13] As of June 30, 2021, based on their financial filings, we estimate the 20 percent floor would have applied to between 57 - 69.5 percent of Fannie Mae's single-family book, and to between 54.1 - 67.9 of Freddie Mac's single-family book.

percent and 20 percent buckets. In other words, reducing the risk weight floor to 15 percent would still leave the Enterprises with highly redundant levels of capital on this group of loans, while making the overall rule somewhat more risk sensitive.

Finally, we note that a 15 percent floor would better align minimum capital requirements with the revised leverage ratio of 3 percent (based on Fannie Mae's PLBA). As shown in Table 10, a 15 percent floor implies a total risk-based capital requirement equivalent to 3 percent of unpaid principal. A 20 percent floor would result in a second, higher leverage ratio requirement on low-risk loans.

Table 8
Expected Lifetime Losses (% of UPB) on 30-Year Loans Impacted by a 20% Risk Weight Floor

OFICO/OLTV	<=30%	<=60%	<=70%	<=75%	<=80%
620-639	0.21%	0.31%			
640-659	0.08%	0.27%			
660-679	0.05%	0.22%			
680-699	0.05%	0.16%			
700-719	0.03%	0.10%			
720-739	0.03%	0.08%	0.22%		
740-759	0.02%	0.05%	0.15%		
760-779	0.01%	0.04%	0.11%	0.18%	
780-999	0.01%	0.03%	0.08%	0.13%	

Table 9
Stressed Lifetime Losses (% of UPB) on 30-Year Loans Impacted by a 20% Risk Weight Floor

	<=30%	<=60%	<=70%	<=75%	<=80%
<620	0.53%	1.40%			
620-639	0.27%	1.70%			
640-659	0.24%	1.44%			
660-679	0.23%	1.22%			
680-699	0.14%	0.87%			
700-719	0.13%	0.74%			
720-739	0.09%	0.56%	1.83%		
740-759	0.07%	0.43%	1.39%		
760-779	0.06%	0.36%	1.06%		
>=780	0.04%	0.24%	0.73%	1.07%	
Total	0.07%	0.46%	1.58%	2.70%	

Table 10
Fannie Mae Capital Requirements for Loans Subject to 15 Percent or 20 Percent RWA Floor

% UPB	15% risk weight floor	20% risk weight floor
CET1 (4.5% RWA)	0.68%	0.90%
CET1 (PCCBA)	1.80%	1.80%
Total CET1	2.48%	2.70%
Other Tier 1 (1.5% of RWA)	0.23%	0.30%
Tier 2 (2.0% of RWA)	0.30%	0.40%
Total Minimum Capital	3.00%	3.40%

Recommendation: Exposures to Another Enterprise Should be Assigned a 0 Percent Risk Weight

In our 2020 Comment Letter, we recommended that FHFA assign a zero percent credit risk capital requirement for an MBS guaranteed by the other Enterprise.[14] In making this recommendation, we argued that the proposed 20 percent risk weight would result in a double capital charge on the securities underlying the MBS. Additionally, because the Enterprises are some of the largest investors in the Uniform Mortgage-backed Security ("UMBS") market, we stated that the 20 percent risk weight would discourage an Enterprise from purchasing UMBS issued by the other Enterprise, thus potentially destabilizing the UMBS market. This, in turn, would decrease liquidity to the UMBS market and ultimately lead to higher mortgage rates for individual borrowers.

In the final ERCF, FHFA did not accept our recommendation and retained the 20 percent risk weight for such exposures. FHFA asserted that this approach does not constitute double counting of the required capital: "An Enterprise issuing and guaranteeing a security backed by the other Enterprise's MBS is not holding capital against the other Enterprise's mortgage exposures, but only against its own exposure to the other Enterprise's guarantee."[15]

We continue to believe that the non-zero risk weight effectively requires added capital due to the use of UMBS without any corresponding change in risk. This capital layering serves to weaken FHFA's objective of ensuring fungibility in UMBS. The ERCF is designed to ensure that each Enterprise can continue to operate through economic cycles, including periods of extreme stress. Moreover, each Enterprise continues to have access to financial support from the Treasury Department. Therefore, we reiterate our recommendation for a zero percent risk weight on these exposures.

Recommendation: Explicitly Address Lender Risk Sharing in ERCF

In our 2020 Comment Letter, we encouraged FHFA to consider the pro-competitive aspects of single-family lender risk-sharing deals and how they may encourage market entry, reduce systemic risk, and improve borrowing rates for consumers.[16] We strongly believe that front-end lender risk-sharing CRT structures should be a core element of risk transfer with

[14] HPC Letter, p. 25.
[15] 85 Fed. Reg. 82183 (Dec. 17, 2020).
[16] 2020 Comment Letter, p. 20.

Enterprise-backed MBS, and the criteria for evaluating the treatment of such structures should be addressed directly in the ERCF.

Lender risk-sharing structures directly contribute to a broader distribution of credit risk in our financial system. They also align the lender's and the Enterprise's interests in the performance and sound servicing of the loans, which has proven to be an extremely strong driver of ***long-term credit performance*** in the Enterprises' multifamily businesses. Another important feature of a lender risk-sharing CRT is that it expands the tool kit for distributing risk from the Enterprises to private investors and brings in additional pools of private capital capable of investing in mortgage credit, thereby further reducing the overall systemic risk posed by the Enterprises.

In addition to fostering competition, which leads to lower mortgage rates, the alignment of interests in front-end lender risk-sharing CRTs creates a more viable residential lending ecosystem, consistent with the spirit of Dodd-Frank risk retention rules that are mandated for the private capital markets. Several HPC members and other lenders have successfully executed front-end lender risk-sharing CRT transactions with the Enterprises and would like to participate again in the future. Other HPC members also have an interest in such transactions and HPC supports efforts by the Enterprises to make this risk-sharing partnership more widely available to any lender who wishes to participate under the offered terms and pricing.

To be clear, HPC's recommendations in support of lender risk-sharing CRTs recognizes and affirms FHFA's authority to set the parameters for approving and monitoring the risk transfer structures for loans sold to the Enterprises. We believe that if FHFA has approved a structure for the Enterprises to use in transferring risk, such a structure should be available for other market participants and should be largely consistent across the various legal structures (counterparty risk, legal enforceability, etc.). Simply put, whether via a security structure or an insurance arrangement, we seek consistency and parity in regulatory treatment of credit enhancement. Moreover, FHFA's authority and oversight should extend to ensuring the protection of not just the Enterprises but also the integrity of the TBA market, the housing finance system, and the stability of the housing markets. This means that FHFA should monitor the pricing of lender risk-sharing CRTs to ensure that they are supportable and market-based, just as it would do with any other similar transactions carried out by the Enterprises.