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

November 23, 2021

RE: RAA Comments in Response to RIN 2590-AB17

Dear Mr. Jones:

This letter is submitted by the Reinsurance Association of America (RAA) on behalf of and in coordination with its numerous interested members in response to the Federal Housing Finance Agency's (FHFA) 2021 notice of proposed rulemaking and request for comments on amendments to the Enterprise Regulatory Capital Framework (ERCF). The proposed amendments make changes to the leverage buffer and the risk-based capital treatment for credit risk transfer (CRT) transactions ("2021 Proposed Amendments"). This letter supplements previously submitted letters by the RAA on August 31, 2020 (Appendix A), and October 14, 2020 (Appendix B) on the FHFA's 2020 notice of proposed rulemaking ("2020 Proposed Rule") and does not supersede the prior analysis or recommendations as expressed in the RAA's previous letters or those letters independently submitted by our members (Aon, Arch, Guy Carpenter, and RenaissanceRe). Rather, the RAA writes to thank the FHFA for its 2021 Proposed Amendments, suggest a near-term adjustment, and provide additional comments for consideration regarding the ERCF and its treatment of CRT. The RAA is a national trade association representing reinsurance companies doing business in the United States. RAA membership is diverse, including reinsurance underwriters and intermediaries licensed in the U.S. and those that conduct business on a cross-border basis.

FHFA's 2021 Proposed Amendments

The RAA appreciates the FHFA's recognition of the value of CRT, which is demonstrated in the FHFA's 2021 Proposed Amendments. We also appreciate that the 2021 Proposed Amendments improve the treatment of CRT under the ERCF, adopted by the FHFA on December 17, 2020. The RAA and its members would suggest one near-term adjustment to the ERCF to further improve the treatment of CRT under the ERCF.

RAA's Suggested Adjustment to The Tranche Risk Weight Floor

The FHFA's 2021 Proposed Amendments retain a 5 percent Tranche Risk Weight Floor, which incentivizes Fannie Mae and Freddie Mac (collectively the "Enterprises") to retain all catastrophic losses, or credit risk beyond the ERCF stress losses, versus transferring that risk to loss-absorbing private capital. In describing the need for the Tranche Risk Weight Floor, the ERCF correctly noted that purchasing CRT that detaches at the net credit risk capital requirement of the underlying mortgage exposures would still pose some credit risk. This is largely based on the uncertainty around the calibration of the capital requirement, although there also is risk from stress scenarios more severe than those contemplated in setting the capital requirement.

The proposed Tranche Risk Weight Floor of a flat 5 percent on the risk weight assigned to retained CRT exposures is an improvement over the current ERCF, but it still distorts incentives over time in two specific ways. First, in most scenarios, the gross capital requirement decreases over time, as loans prepay and amortize, and current loan-to-value ratios decrease. With a flat 5 percent Tranche Risk Weight Floor, the required capital for a pool with CRT protection decreases much more slowly than the required capital for a pool without CRT. In benign scenarios, the capital requirement declines faster than the CRT detachment point resulting in CRT limits that do not receive capital credit yet still have to be paid. Second, with a flat Tranche Risk Weight Floor, there is no incentive for the Enterprises to purchase CRT coverage above the net credit risk capital requirement as the incremental capital benefit for the additional coverage is de minimis. Since there is a legitimate concern with uncertainty around the calibration of the capital requirement, this lack of incentive is not desirable, as the purchase of additional limit could directly address the uncertainty and sensibly reduce the risk to the Enterprises.

There are multiple ways that the Tranche Risk Weight Floor could be restructured to better align the incentives of the Enterprises with prudent risk management by providing capital benefit for any purchase of CRT that materially reduces the retained risk to the Enterprises. One option is for the FHFA to allow an offset to the Tranche Risk Weight Floor haircut in the 2021 Proposed Amendments for CRT coverage purchased above the stress loss amount. Another option is to construct a tiered Tranche Risk Weight Floor, where increasing amounts of limit purchased reduce the net capital requirement at a declining rate.

These recommendations allow room for prudent risk management without penalizing or disincentivizing cost effective risk-transfer activity, which may be in the best interests of Enterprise stability and long-term survival. Any additional CRT would further diversify taxpayer protection into the private sector with resulting efficiencies delivered to homeowners in the form of reduced guarantee fees and/or to affordable programs in the form of increased incentives.

We refer the FHFA to our members' (Arch, Aon, and Guy Carpenter) more detailed recommendations regarding this proposal in their November 2021 responses to the FHFA's 2021 Proposed Amendments.

Additional Comments for Consideration

As stated in the previous letters and comments of both the RAA and its members, we advocated for the elimination of the ERCF's Tranche Risk Weight Floor over the elimination of the Overall Effectiveness Adjustment as the most consistent, effective, and fair approach to the treatment of CRT for duration of the coverage term. The RAA would welcome the opportunity to engage in a productive dialogue with the FHFA about incentivizing CRT through time, under a dynamic ERCF, that would consistently recognize CRT for the full term of the coverage, reflecting the level of protection provided from day one until the conclusion of the contract.

The RAA also would recommend two new clarifications within the ERCF. First, enhancements and structural changes to the CRT transactions, as well as alternative risk transfer structures undergo rigorous review and approval by the FHFA. That collaborative process allows both the FHFA and Enterprises to scrutinize the efficiency and efficacy of those structures. However, the ERCF is unclear as to which transactions require public notice and comment, creating a potential barrier to innovation. To continue to encourage collaborative and adaptive CRT innovation, which has been a distinct hallmark of the CRT transactions, the FHFA should remove altogether the provision mandating notice and public comment. To the extent that the FHFA determines certain new structures could benefit from notice and public comment, the FHFA can do so now. Requiring notice and comment as a precondition only stifles the incremental innovation necessary in an ever-evolving market. This latitude is particularly important for new affordable housing initiatives which usually require non-traditional solutions. Second, the FHFA should clarify the ERCF language to explicitly confirm the Enterprises' deal cancellation provision as a standard option for CRT transactions to provide flexibility to the Enterprises to make reasoned risk-based CRT adjustments, as needed.

When contemplating specific changes to the ERCF to improve the treatment of CRT, the RAA recommends that they be considered in the context of the entirety of the ERCF, such that the leverage ratio functions as a credible backstop and not a frequently binding alternative measure which can distort needed risk-based decisioning.

Modifications to PSPAs

As recognized in the FHFA's 2021 Proposed Amendments, the U.S. Department of the Treasury and the FHFA must modify the preferred stock purchase agreements (PSPAs) relating to the Enterprises for the FHFA to implement any changes to the ERCF. The RAA supports amending the PSPAs to allow the ERCF to be modified in light of the 2021 Proposed Amendments and recommendations suggested by the RAA and our members.

Conclusion

Thank you for the proposed, positive changes in the FHFA's 2021 Proposed Amendments. The RAA's membership remains in unanimous agreement that without amendments, the ERCF devalues CRT. Our members have slightly different views on the path forward but agree that the FHFA's 2021 Proposed Amendments improve the treatment of CRT. Our members also agree that the RAA's proposed adjustment herein could further improve the ERCF's risk-based treatment

of CRT. Lastly, we again point to the independent and directionally aligned responses to the FHFA's 2020 Proposed Rule and/or 2021 Proposed Amendments of Aon (reinsurance broker), Guy Carpenter (reinsurance broker), Arch (mortgage insurer and reinsurer), and Renaissance Re (reinsurer), which represent the central thrust of the RAA's views and are recommended for consideration by the FHFA as a basis for reinstating the value of CRT.

Thank you for the opportunity to provide comments. The RAA and its members would be happy to engage with you on the recommendations in this letter and/or previous letters or answer any questions you may have.

Sincerely,

Frank Nutter
President

APPENDIX A

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
Eighth Floor
400 Seventh Street, SW
Washington, DC 20219

August 31, 2020

RE: RAA Comments in Response to RIN 2590-AA95

Dear Mr. Pollard:

This letter is submitted by the Reinsurance Association of America (RAA) on behalf of and in coordination with its numerous interested members in response to the FHFA 2020 notice of proposed rulemaking ("2020 Proposed Rule"). RAA is a national trade association representing reinsurance companies doing business in the United States. RAA membership is diverse, including reinsurance underwriters and intermediaries licensed in the U.S. and those that conduct business on a cross-border basis.

INTRODUCTION

Since 2013, the reinsurance industry has supported the transfer of mortgage credit risk from government-sponsored entities Fannie Mae and Freddie Mac (collectively the "Enterprises") to our private sector balance sheets as part of their rehabilitation during government conservatorship.[1] RAA's membership includes companies across the entire value chain of mortgage credit risk transfer, from brokers to private mortgage insurers to reinsurers. We urge you to consider these comments as a complement to those submitted by individual RAA members.

Prior to the 2008 financial crisis, the Enterprises entirely retained 100% of the mortgage credit risk they accumulated until 2013, when the credit risk transfer (CRT) program began. The success of the CRT program renewed confidence in the revised practices of the Enterprises and, until FHFA's 2020 Proposed Rule, had been a priority of the FHFA. The CRT program has transferred substantial risk from U.S. taxpayers to the private sector. The objective third-party view of reinsurers and investors willing to regularly evaluate and partner in this risk also has oversight benefits far beyond government-required capital and the limits of governmental supervision.

In May 2020, the FHFA re-proposed a new Enterprise Regulatory Capital Framework, using its 2018 proposed rule as a "foundation".[2] The new proposal calls for sweeping and comprehensive changes, including changes that have severe, and negative, impacts on the capital relief the Enterprises would receive from CRT. At its core, the proposal has laudable goals and a workable

framework, but some adjustments and alternatives are needed to better achieve the FHFA's goals and preserve CRT for the benefit of the Enterprises and, ultimately, U.S. taxpayers, homeowners and renters.

EXECUTIVE SUMMARY/KEY TAKEAWAYS

As applied, the FHFA's proposed new capital framework would effectively eliminate CRT, which has been a successful post-2008 financial crisis risk management tool for the Enterprises since its inception. Disincentivizing the CRT market would result in severe consequences for the residential housing market and return the Enterprises to a "relative" of their pre-2008 model, when the Enterprises were owned by equity shareholders and retained 100% of their mortgage credit risk, resulting in substantial exposure to U.S. taxpayers. Diminishing the value of CRT would result in:

- Increasing risk of loss to U.S. taxpayers, particularly during periods of economic turmoil, such as the COVID-19 pandemic;
- Jeopardizing or delaying the Enterprises' exit from conservatorship due to the increased risk that the Enterprises will not be able to raise the unprecedented levels of equity capital required under the proposal, or at the very least, extending the time it will take to raise that capital;
- Raising the cost of housing for homeowners and renters through increased guarantee fees ("g-fees") necessary to replace the lower cost CRT capital; and
- Pushing greater risk of loss to the Federal Housing Administration (FHA), the Federal Deposit Insurance Corporation (FDIC), and potentially the Board of Governors of the Federal Reserve System (Federal Reserve).

The 2020 Proposed Rule requires the Enterprises to hold capital of at least $243 billion. This amount: is nine times the $28 billion of capital held as of August 2020; requires the Enterprises to raise additional capital that is seven times larger than the largest initial public offering in world history ($29.4 billion raised by Saudi Aramco in 2019); and is six times higher than the $43 billion Dodd-Frank Stress Act Test for the severe adverse scenario. Exclusive reliance on equity capital of that size without the benefits and diversification of CRT would be risky and expensive.

The FHFA should avoid these consequences by revising its 2020 Proposed Rule to recognize the value CRT provides to the Enterprises, homeowners, renters and taxpayers. With suitable improvement to its 2020 Proposed Rule, the FHFA can still achieve its objectives and preserve the benefits that CRT provides for the Enterprises today, including:

- loss-absorbing transfer of risk to the private sector to protect taxpayers during times of stress;
- a bridge to raise equity capital; and
- cost-effective capital relief and housing affordability.

BACKGROUND

The Enterprises are corporate entities created by Congress to extend financing liquidity for single-family homeowners and multifamily, rental property owners.[3] The impact of post-crisis reforms

is that the Enterprises no longer purchase mortgage-backed securities to hold in their asset portfolio. The Enterprises are essential to the functioning of the U.S. mortgage and housing market, however, because they finance about half of all U.S. mortgages and in the process guarantee the credit risk on those mortgages.

Excessive risk-taking and insufficient capital precipitated the Enterprises' losses during the 2008 financial crisis. The resulting losses prohibited the Enterprises from fulfilling their mission without government intervention, and as such, the FHFA placed both entities into conservatorship at substantial initial cost to taxpayers.

Following the 2008 financial crisis, under two Administrations from different political parties, the FHFA has directed the Enterprises to strengthen, diversify, and increase private capital. The Enterprises have achieved this by enlisting the private sector to provide real-time, objective, third-party feedback to help the Enterprises better evaluate, price, manage, and reduce risk,[4] through the FHFA's formation of the CRT program. CRT operates like an insurance contract, transferring a portion of the Enterprises' mortgage credit risk to private markets. Suitable application of CRT:

- protects U.S. taxpayers and Enterprise shareholders from losses;
- enhances each Enterprise's safety, soundness, and resiliency;
- provides valuable feedback to the Enterprises on credit costs and on underwriting standards; and
- supports affordable housing for homeowners and renters.

Starting in 2012, FHFA's strategic plan for the Enterprises' conservatorships first directed the Enterprises to transfer mortgage credit risk to the private sector.[5] FHFA has continued to reference this goal as recently as FHFA's June 2020 Annual Report to Congress.[6] The report also states that:

> CRT will continue to be a component of the Enterprises' approach to risk management. Continuing to transfer risk to private sources of capital both reduces risk to taxpayers and provides a measure of market discipline otherwise lacking under conservatorship.[7]

Moreover, at a recent House Financial Services Committee hearing, Treasury Secretary Steven Mnuchin confirmed the Administration believes the Enterprises should receive equitable capital relief for their CRT transactions.[8]

To date, the Enterprises have transferred over $130 billion of mortgage credit risk on over $4 trillion of single-family and multifamily mortgages through more than 200 CRT transactions.[9] Of that, $30 billion of single-family risk and $2 billion of multifamily risk was transferred to over 40 highly-rated, diversified and well capitalized (re)insurers.[10] Indeed, the Enterprises have transferred risk on the vast majority of the business they have acquired since 2013 to private investors and (re)insurers. The CRT program is in fact modeled after reinsurance catastrophe bonds that transfer peak losses from natural catastrophes.[11]

CRT is either fully collateralized or partially collateralized by highly rated, diversified reinsurers, which means that the collateralized funds are stored in trust, and therefore guaranteed to be recoverable by the Enterprises in the event of a triggering loss. The presence of this private sector risk transfer support explicitly reduces the risk of systemic defaults that can destabilize the U.S. mortgage and housing markets and financial systems during periods of stress like the 2008 financial crisis.

According to the FHFA's April 2020 Credit Risk Transfer Progress Report, "…the Enterprises purchase insurance primarily from diversified reinsurers. These transactions are partially collateralized and distributed among a variety of highly-rated insurers, reinsurers, and reinsurer affiliates of mortgage insurers, which reduces counterparty, reimbursement, and correlation risk." The report further states that "[r]einsurers are often characterized by diversified lines of business, which helps mitigate the risk that the Enterprises' counterparties are correlated to housing market stress and would have increased claims at the same time the Enterprises themselves are under stress."[12]

As recognized by the Department of Treasury, "[t]he [Enterprises'] CRT programs enhance taxpayer protection and foster price discovery and market discipline, and in light of these features, the FHFA should continue to support efforts to expand these programs."[13] Further, Treasury recommended that "FHFA should, in prescribing regulatory capital requirements, provide for appropriate capital relief to the extent that a guarantor, or a [Enterprise] pending legislation, transfers mortgage credit risk through a diverse mix of approved forms of CRT."[14]

To date, the Enterprises have $112 billion of CRT coverage limits available (combined single-family and multifamily).[15] Stress losses from a replay of the 2008 crisis would result in an estimated $41 billion of credit risk losses transferred to private CRT investors, using the CRT capital impact from FHFA's 2018 proposed capital rule as a proxy.[16]

In relevant part, the purpose of the 2020 Proposed Rule is to create a framework of incentives under which the Enterprises will operate. The rationale for the rule is three-fold: (1) position the Enterprises to exit conservatorship; (2) increase the quantity and quality of capital held by the Enterprises; and (3) mitigate pro-cyclicality. Striking a balance between protecting taxpayers from future losses and maintaining affordability are key issues to address.

BENEFITS OF CREDIT RISK TRANSFER

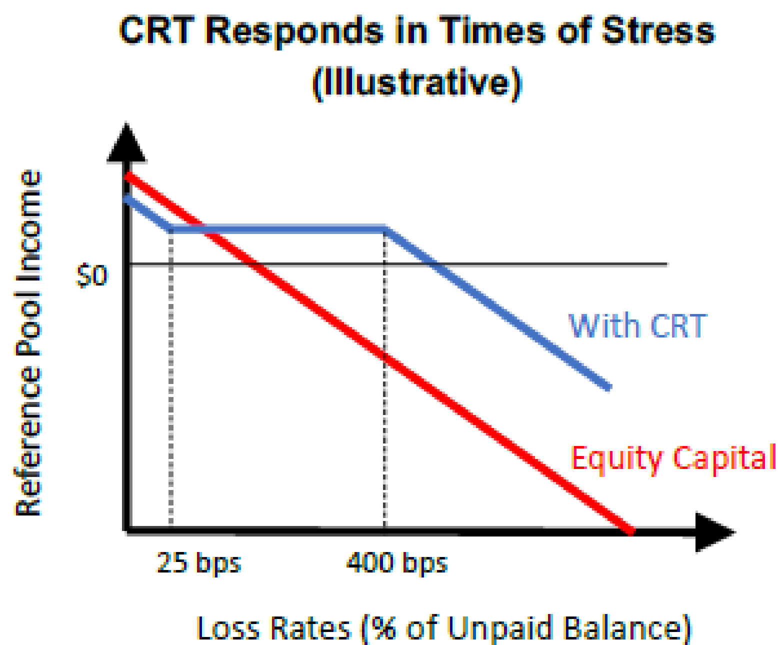
At a high level, CRT transfers mortgage credit risk from Enterprises to the private sector, protects taxpayers, and reduces costs to the Enterprises and to homeowners and renters. Through CRT, the private sector has enabled the Enterprises to become efficient distributors of risk, with a large, diverse group of private (re)insurers and investors.

CRT Protects Taxpayers (and the Enterprises)

Deteriorating economic conditions such as high unemployment or house price declines increase the possibility of future losses to taxpayers. The presence of CRT equips the Enterprises to weather

these times of distress because it transfers stress losses to the private sector, reducing earnings volatility and minimizing risks for the Enterprises.

The illustration below shows the different results for a reference portfolio with and without CRT. As the loss rate to a portfolio increases, the expected income to the pool decreases. However, the presence of CRT caps the downside to the Enterprises and results in greater certainty of income for the Enterprises. In the face of an uncertain housing market, having a reference pool that is protected by CRT effectively covers deterioration, which leads to a material benefit to the shareholders.



CRT helps to avoid financial distress in the Enterprises and the subsequent burden on taxpayers. Sudden and unexpected deterioration in credit conditions (such as those we are currently experiencing due to COVID-19) introduces a significant amount of uncertainty around the magnitude of losses, which can be reduced through the effective use of CRT. The Enterprises account for this uncertainty through loan loss provisions that are subject to development over time. Evidence demonstrates how CRT stabilizes these loan loss provisions in Freddie Mac 2020 Q1 and Q2 earnings.[17]

The presence of this effective indemnity in CRT results in a number of benefits to the stakeholders in the Enterprises. During periods of stress losses, CRT essentially creates a "capital call" that causes capital to flow from (re)insurers to the Enterprises in periods where debt and equity capital costs are highest. As a result, CRT reduces the volatility of earnings and thus the volatility of capital.

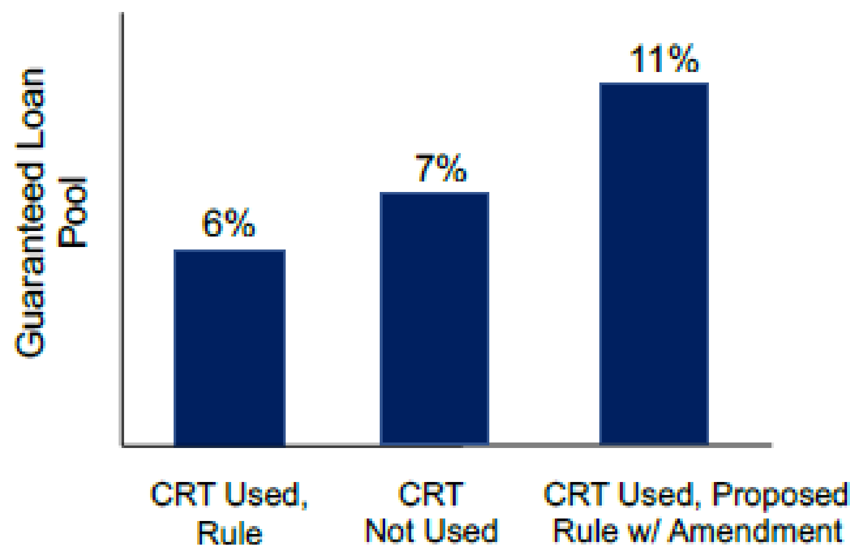
CRT Supports Effective Management of Liquidity Risk

CRT also provides an effective source of feedback to the Enterprises about risks contained in the portfolio. If reinsurers see underwriting or credit conditions deteriorating or the Enterprises increasing the risk in their new guarantees, reinsurers will respond with live pricing feedback of products to the Enterprises, which has a material benefit to the risk management teams in the Enterprises.

Reinsurers that participate in CRT are fully subject to solvency regulation by state insurance departments to the same extent and in the same manner as insurance companies. Because of collateralization and regulatory oversight of reinsurers, counterparty risk is de minimus.

CRT Better Positions the Enterprises to Raise Capital

CRT better positions the Enterprises to raise the capital they need to emerge from conservatorship. CRT can act as a bridge to the private capital the Enterprises need to raise, both by reducing the overall level of equity capital they need to raise initially, and by helping to attract the necessary capital by improving Enterprise returns through the use of lower cost CRT capital. Given the extraordinary scale of the capital raise contemplated by the 2020 Proposed Rule, maintaining the incentives to use CRT and the benefits that derive from it is essential.



Sources: FDIC, Bloomberg, Guy Carpenter

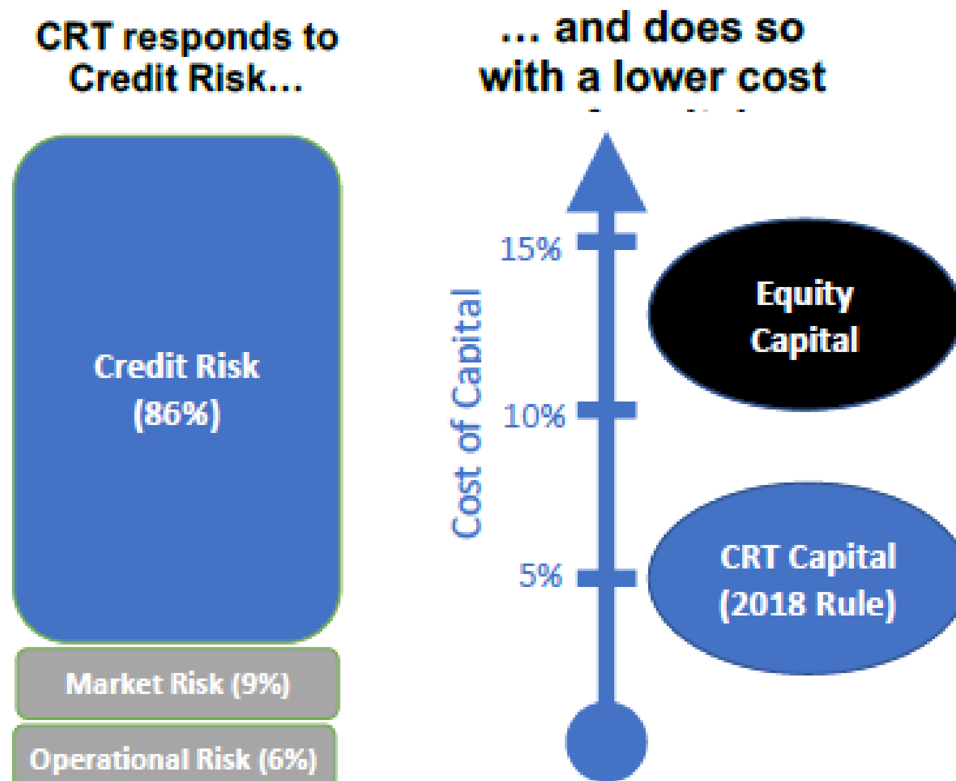
Assumes CIRT 2020-1 guaranteed loan pool with 10 bps credit loss and 25 bps non-credit costs,

Under the 2020 Proposed Rule and the 2020 reference pool, the Enterprises' return on equity without using CRT is expected to be approximately 7%. As proposed, the presence of CRT actually reduces the return on equity (ROE) down to approximately 6% because the costs under the current proposal are not offset by a corresponding capital benefit. The 2020 Proposed Rule

therefore directly disincentivizes the purchase of CRT protection from the private sector because it would deteriorate the returns that are available to shareholders of the Enterprises.

Under the 2020 Proposed Rule, Enterprise returns of 6% would be inferior to banks and other financial institutions, making it difficult or impossible for the Enterprises to raise capital. Banks and financial institutions typically require 10-15% expected shareholder returns. The only way for the Enterprises to remedy their inferior returns will be to increase fees, which will raise mortgage costs and pressure affordability. The proposed modifications the RAA supports (discussed below) and that also are reflected in the comments of individual RAA members would create a framework where the Enterprises are incentivized to use CRT, which will bring their returns in line with banks and other financial institutions, making the Enterprises more attractive to investors and placing the Enterprises on a more even footing with others in a competitive marketplace for the capital. The suggested modifications to the 2020 Proposed Rule of RAA and its members therefore allow the Enterprises to achieve their mission to U.S. homeowners and positions the Enterprises to exit conservatorship.

The Enterprises become more attractive to investors by enhancing equity capital.



Source: Enterprise Regulatory Capital Framework NPR - Table 2

As noted in table 2 of the 2020 Proposed Rule, as illustrated above, 86% of the Enterprises' total risk landscape consists of mortgage credit risk, and CRT responds to this driving risk of the Enterprises with a lower cost of capital. The Enterprises have shown that, if properly incented, they will utilize CRT to protect taxpayers. Moreover, the CRT execution experienced by the

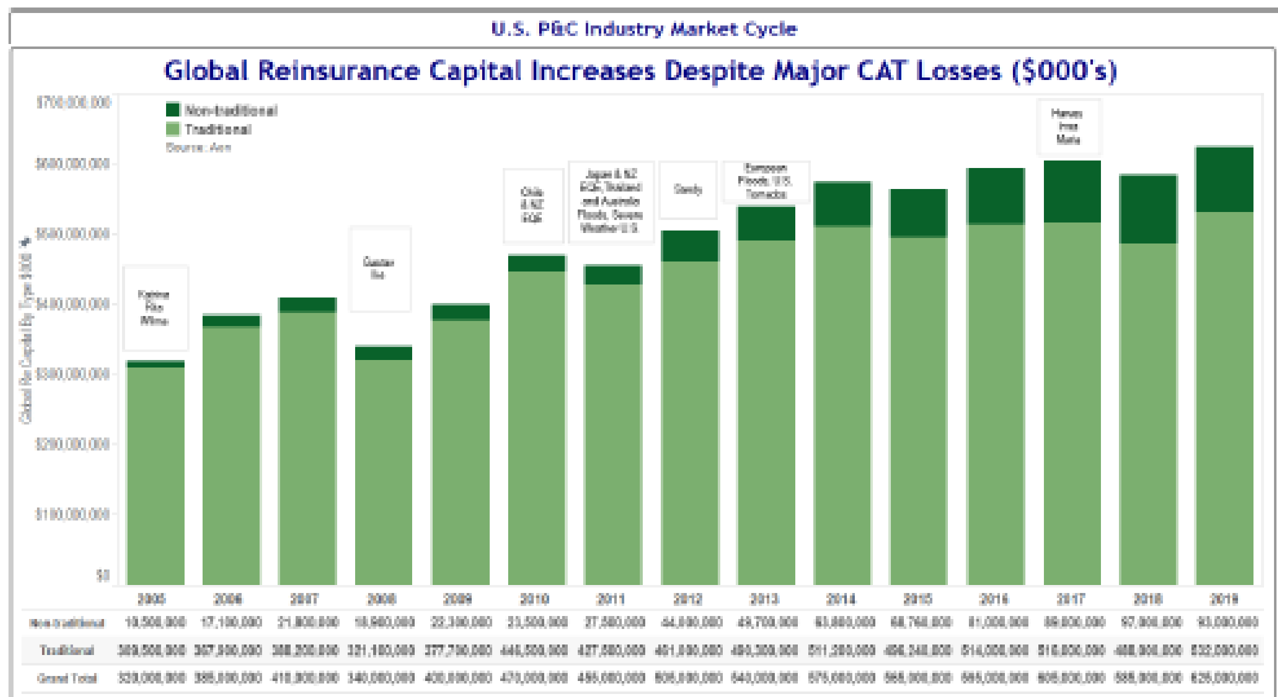
Enterprises in recent years has been extremely efficient. As a result, it is clear that the cost of CRT capital is substantially lower than the cost of alternative equity capital.

At the same time, CRT provides the additional benefit of capital diversification, and reduces volatility. It complements equity capital and, by lowering the cost of capital, helps preserve housing affordability. In addition, diversified sources of capital increase Enterprise durability through the cycle. That diversification is further achieved by two different types of CRT execution – the capital markets and the reinsurance markets. Capital markets represent approximately 75% of the CRT that has been transferred to the private sector to date, and reinsurers represent the other 25%. Reinsurance companies have diverse, non-correlated portfolios that enable counter-cyclical capital support. The ability of reinsurers to respond to changing market conditions highlight that diversity of thought and diversity of appetite. That diversity includes the ability to provide commitments to take on mortgage credit risk that is accepted by the Enterprises in the *future* (through "forward" transactions) and other custom-tailored solutions that can adjust to the prevailing conditions. Notably, after COVID-19 temporarily halted CRT transactions, there has been a continued issuance of both reinsurance and capital markets CRT transactions. In fact, the reinsurance market was the first to re-enter the CRT market to provide capacity with new CRT offerings. To date, every CRT transaction the Enterprises have brought to market has been successfully placed. Given the inherent instability that could come from a crisis, having as many sources of this diversified capital as possible (including reinsurance capital) is incredibly valuable to the Enterprises.

ROLE OF REINSURANCE

As noted above, reinsurers have been an effective and important piece of the CRT program. Reinsurance is a risk management tool for insurance companies that can be used to reduce the volatility in their insurance risk portfolios and to improve their financial performance and security. Insurance and reinsurance as financial risk management tools are inherently counter-cyclical: in times of strong mortgage performance, the expected premium outlay will be greater than the expected claim benefit, but in a stress scenario, the claim benefit received can dwarf the cost of the premiums paid. The effectiveness of reinsurance as a risk management tool is enhanced to the extent it can spread risk over the broadest possible base of responsible capital.

It is widely recognized that reinsurance performs at least four primary functions in the marketplace: to limit liability on specific risks; to stabilize loss experience; to provide coverage for insurers of major natural and man-made catastrophe risk; and to increase insurance capacity. By helping to mitigate the potential losses that could result from risks such as major new construction projects or breakthrough technologies, reinsurers help enable innovation. Finally, reinsurers play an important advisory role based upon their often-greater experience with certain insurance markets and products and the underwriting experience from a wide range of insured populations across the globe. By writing diversified insurance risk from around the world, reinsurance companies avoid overexposure and act as a stabilizing force in local insurance markets. Reinsurance takes the volatility out of insurer financial performance over time. Indeed, as illustrated in the chart below, in the wake of a major event or crisis, reinsurers typically proactively look to take on additional risk, resulting in a growth in reinsurance capital post event.



	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Non-traditional	19,500,000	17,100,000	21,800,000	18,980,000	22,300,000	23,500,000	27,580,000	44,000,000	49,700,000	63,800,000	68,760,000	81,000,000	89,000,000	97,900,000	93,000,000
Traditional	309,500,000	367,900,000	388,200,000	321,100,000	377,700,000	446,500,000	427,580,000	461,000,000	490,300,000	511,200,000	496,240,000	514,000,000	516,000,000	488,900,000	532,000,000
Grand Total	329,000,000	385,000,000	410,000,000	340,080,000	400,000,000	470,000,000	455,080,000	505,000,000	540,000,000	575,000,000	565,000,000	595,000,000	605,000,000	585,900,000	625,000,000

Reinsurance has proven to be a stable source of capital that responds proactively to crises and continues to deploy capacity.

As of Q1 2020, the global reinsurance market represents approximately $600 billion of capital[18] and already provides meaningful support to the private market, the Enterprises, and government programs, such as the National Flood Insurance Program and Export-Import Bank of the U.S. These entities have successfully transferred risk to reinsurance companies and their affiliates, simultaneously protecting taxpayers while helping families and businesses in the private sector. After hurricane Harvey in 2017, reinsurers absorbed over $1 billion to help pay NFIP claims.[19] Claims were paid by the reinsurance market within seven days. Despite this total loss to their reinsurance limit in the first year of the program, the reinsurance markets not only renewed, but increased their coverage for 2018.[20] This is just one clear example of how reinsurance helps to stabilize the economy after crisis events and remains viable as a market following major events with significant insured losses. Reinsurance by its nature is used to support business through the cycle, even in the period immediately following a major event/loss.

<u>KEY FEATURES OF 2020 PROPOSED RULE THAT EFFECTIVELY ELIMINATE CRT</u>

The 2020 Proposed Rule has three key features that create negative housing market impacts through the effective elimination of CRT. These features are:

1. New leverage ratio cap;

2. New minimum tranche risk weight floor; and
3. New overall effectiveness adjustment.

The combined impact of these three features is to make risk transfer to the private sector uneconomical. Effectively, these features eliminate CRT by destroying the incentives to transfer risk. The overall impact of these changes is significant.

If CRT is not used as a source of capital, then a greater amount of equity capital would be required, raising the execution risks needed to exit conservatorship. It also increases the time needed to exit conservatorship, as it will take more time to raise additional levels of capital or more time for earnings to reach the necessary levels. The 2020 Proposed Rule requires the Enterprises to hold capital of at least $243 billion, and in order to operate responsibly, they would inevitably need to impose their own buffer above the required level to avoid facing a regulatory cliff in their everyday operations. The amount is extraordinary (as discussed more fully below) and would take years to accumulate.

Reliance on a single source of capital (equity) makes the Enterprises less durable through the cycle. The Enterprises can never be sure that they will be able to replenish their equity capital in a time of crisis, but if the Enterprises had multiple sources of capital, they could be more durable and more diversified. In addition, sole reliance on the more expensive form of capital means that higher g-fees would be needed. This will result in increases in the cost of housing for homeowners and renters.

The Enterprises also compete in the marketplace with another federal government-created and taxpayer-backed program, the FHA. If the 2020 Proposed Rule increases the cost of Enterprise loans, then it is inevitable that a significant portion of the mortgage business will be diverted to the FHA. This puts taxpayers at risk because there is no mechanism at the FHA to transfer risk to the private sector.

OBSERVATIONS AND IMPACTS OF THE PROPOSED RULE

The 2020 Proposed Rule is an inversion from the FHFA's prior plans and reports and would penalize the Enterprises for transferring mortgage credit risk to third parties. The RAA respectfully makes the following observations on the proposed rule, along with the impact of each of those observations.

Observation 1: The 2020 Proposed Rule requires the Enterprises to hold capital to the higher of the leverage ratio and risk-based capital requirements. Under the first standard, the non-risk-based, leverage ratio requirement, the Enterprises receive absolutely zero capital credit for CRT (and in practice the costs they pay for the risk transfer protection will reduce their overall returns). Under the risk-based capital requirement, the Enterprises would receive less than *half* the credit they receive today over the life of the CRT transactions.

> **Impact:** Requiring the Enterprises to comply with the higher of the two capital requirements threatens to eliminate the successful CRT program, which would be detrimental to risk management, taxpayers, homeowners, and renters. There is no incentive

for the Enterprises to use CRT going forward, given that the 2020 Proposed Rule materially devalues CRT. In fact, in some cases, the 2020 Proposed Rule would actually impose negative capital credit because the Enterprises will be required to hold more capital on mortgages that are covered by CRT than they would hold if they kept 100% of the risk themselves. The publication of the 2020 Proposed Rule already has caused Fannie Mae to hit "pause," stating it "currently [does] not have plans to engage in additional credit risk transfer transactions as [it] evaluate[s] FHFA's recently re-proposed capital rule, which would reduce the amount of capital relief [it] obtain[s] from these transactions."[21] Without CRT, the Enterprises will regress to a pre-2008 financial crisis state, where equity shareholders retain all of the Enterprises' mortgage credit risk.

Observation 2: The 2020 Proposed Rule emphasizes the quality of equity capital and devalues CRT.

Impact 1: Without CRT, the Enterprises lose a valuable source of diversifying external capital, making them too reliant on equity shareholders. Moreover, it will make the Enterprises less durable across the economic cycle, jeopardizing the Enterprises' safety and soundness and increasing the likelihood of a future U.S. taxpayer bailout.

Impact 2: Sole reliance on more expensive equity capital will require the Enterprises to take on more risk and/or increase their guarantee fees (g-fees) to satisfy minimum returns demanded by equity shareholders. Increasing g-fees will increase costs for borrowers and divert new mortgages to the 100%, federally-backed, FHA, increasing taxpayer risk and running counter to the Administration's housing reform plans.[22]

Impact 3: Devaluing CRT will reduce the Enterprises' loss-absorbing capacity. CRT does not respond to market and operational risk, but it does respond to the dominant risk (credit risk) which comprises 86% of the overall risk held by the Enterprises.

Impact 4: The Enterprises would lose valuable private market feedback and price discovery on the credit risk which they guarantee.

Observation 3: The 2020 Proposed Rule requires the Enterprises to hold capital of at least $243 billion. This amount: is nine times the $28 billion of the capital held as of August 2020; requires the Enterprises to raise additional capital that is seven times larger than the largest initial public offering in world history ($29.4 billion raised by Saudi Aramco in 2019); and is six times higher than the $43 billion Dodd-Frank Act Stress Test for the severe adverse scenario.

Impact: Without CRT, it will take five to ten years for the Enterprises to raise the required amount of capital, further delaying their exit from conservatorship and exposing taxpayers during this period.[23]

<u>SUGGESTED MODIFICATIONS</u>

RAA's membership is in unanimous agreement that the Proposed Rule devalues CRT. Our members have slightly different views on the path forward but share similar concerns about the

five issues outlined below. The independent and directionally aligned responses to the proposed rule of AON (reinsurance broker), Guy Carpenter (reinsurance broker), Arch (mortgage insurer and reinsurer) and Renaissance Re (reinsurer) represent the central thrust of the RAA's views and are recommended for consideration by FHFA as a basis for reinstating the value of CRT.

Leverage Ratio

The Leverage Ratio, the current binding constraint, does not provide capital credit for risk transfer. RAA believes that risk transfer should receive equal capital treatment under the Leverage Ratio and Risk-Based Capital requirements.

The Rule also proposes a Leverage Ratio set at 2.5% of total adjusted assets, plus 1.5% of Tier 1 Capital as the Prescribed Leverage Buffer Amount ("PLBA"), for a total Leverage Ratio of 4% of adjusted assets. The consequences of this higher ratio and proposed additional modifications at a lower level of calibration are discussed at length in our members' individual comment letters.

Tranche Risk Weight Floor

The Tranche Risk Weight Floor is designed to ensure that no retained exposure carries a zero capital requirement. RAA appreciates the rationale for the rule but we believe that its level of conservatism has inherent flaws. We refer FHFA to our members' recommendations regarding its removal or modification with an intention to incentivize proper risk management behavior.

Overall Effectiveness Adjustment

RAA recognizes the Overall Effectiveness Adjustment is intended to compensate for the superior flexibility, fungibility and loss-absorbing capacity of equity capital. While CRT capital may not have the same attributes as equity capital, RAA strongly believes that embracing diverse forms and sources of capital is essential to ensuring the quality, quantity, and loss-absorbing capacity of Enterprise capital across economic cycles.

Risk-Based Buffers

The risk-based capital requirements include three buffer amounts: the countercyclical (currently set at zero), stress, and stability capital buffers. The stress and stability buffers comprise almost 80% of the total risk-based capital requirements, which presents some of the same risks and issues as an overly conservative Leverage Ratio. RAA members' comment letters present the case for recalibrating the buffers making them more sensitive to risk.

Counterparty Assessment Should be Transparent and Objective

The Proposed Rule is opaque as it respects the counterparty assessment process. RAA members encourage FHFA to provide further transparency on the assessment of mortgage concentration and counterparty ratings. The goal of such transparency is to create "virtuous competition".

CONCLUSION

As set forth above, while RAA recognizes that the FHFA's 2020 Proposed Rule has worthy objectives, as drafted, it would effectively eliminate CRT, destroying CRT's ability to enhance equity capital and limit taxpayer exposure to catastrophic mortgage credit losses. CRT is a valuable component of exiting conservatorship because:

- CRT works today to transfer risk to the private sector and can be a valuable bridge to recapitalization of the Enterprises;
- CRT protects taxpayers from the Enterprises' core mortgage credit risk;
- CRT improves housing affordability by lowering costs to homeowners and renters through a lower cost of capital (compared to equity capital);
- CRT increases certainty and improves stability through the cycle;
- CRT is an important source of diversified external capital; and
- CRT provides valuable feedback to the Enterprises on credit costs and on underwriting standards.

As a result, the RAA strongly believes that the 2020 Proposed Rule should be modified to provide robust incentives for the Enterprises to continue to use CRT.

Thank you for the opportunity to provide comments. The RAA and its members would be happy to brief you regarding the recommendations in this letter or answer any questions you may have.

Sincerely,

Frank Nutter
President

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[1] https://crt.freddiemac.com/offerings/acis.aspx#document-details
https://capmrkt.fanniemae.com/portal/funding-the-market/credit-risk/credit-insurance-transactions-servicing-reports.html
[2] https://www.govinfo.gov/content/pkg/FR-2020-06-30/pdf/2020-11279.pdf;
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[5] https://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Credit-Risk-Transfer.aspx#:~:text=%E2%80%8BCredit%20Risk%20Transfer%E2%80%8B&text=In%202012%2C%20the%20Federal%20Housing,to%20taxpayers%20while%20in%20conservatorship.

[6] https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/20120221_StrategicPlanConservatorships_508.pdf; https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2019_Report-to-Congress.pdf

[7] *Id.*

[8] Transcript of Hearing of the U.S. House Committee on Financial Services. "Oversight of the Treasury Department and Federal Reserve's Pandemic Response," June 30, 2020.

[9] Aon plc.

[10] Aon plc; Don Layton (https://www.jchs.harvard.edu/blog/demystifying-credit-risk-transfer/)

[11] Don Layton (https://www.jchs.harvard.edu/sites/default/files/harvard_jchs_gse_crt_part2_layton_2020.pdf)

[12] https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Progress-Report-4Q2019.pdf

[13] U.S. Department of Treasury Housing Reform Plan, September 2019.

[14] *Id.*

[15] Aon plc; http://www.freddiemac.com/investors/financials/pdf/10k_021320.pdf; https://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2019/q42019.pdf; https://www.fanniemae.com/portal/funding-the-market/credit-risk/multifamily/mf-credit-insurance-risk-transfer.html; https://freddiemac.gcs-web.com/news-releases/news-release-details/freddie-mac-closes-18-billion-mcip-reinsurance-transaction; https://freddiemac.gcs-web.com/news-releases/news-release-details/freddie-mac-announces-first-multifamily-credit-risk-transfer; and https://freddiemac.gcs-web.com/node/18646/pdf

[16] https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/Webinar_642020.pdf

[17] Freddie Mac 2020Q1 earnings release (http://www.freddiemac.com/investors/financials/pdf/2020er-1q20_release.pdf)

[18] http://thoughtleadership.aonbenfield.com/Documents/20200710-re-analytics-reinsurance-market-outlook-junejuly.pdf; Guy Carpenter estimates $435 billion in dedicated reinsurance capital as of midyear 2020.

[19] Page 59, https://www.whitehouse.gov/wp-content/uploads/2018/02/budget-fy2019.pdf; https://www.fema.gov/news-release/20200220/fema-will-recover-1042-billion-reinsurance-private-reinsurance-markets; https://www.fema.gov/news-release/20200220/fema-reflects-historic-year; and https://www.fema.gov/media-library-data/1522167351921-a5e457454262dd100e2f15a7210d21c5/Watermark_FY18_Q1_v6_508.pdf

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[22] https://home.treasury.gov/news/press-releases/sm769

[23] https://www.cbo.gov/system/files/2020-08/56496-GSE.pdf; Aon plc

APPENDIX B

The Honorable Mark Calabria
Director
Federal Housing Finance Agency
Eighth Floor
400 7th Street, SW
Washington, DC 20219

October 14, 2020

RE: RAA Additional Comments in Response to RIN 2590-AA95

Dear Director Calabria:

This additional comment letter is submitted by the Reinsurance Association of America (RAA) on behalf of, and in coordination with, its numerous interested members. This letter supplements the letter RAA previously submitted during the comment period on FHFA's 2020 notice of proposed rulemaking ("2020 Proposed Rule"). This letter is not intended to supersede the prior analysis or recommendations as expressed in RAA's previous letter or those letters independently submitted by our members (Aon, Arch, Guy Carpenter, and RenaissanceRe). Rather, RAA respectfully proposes two critical, revised modifications to the 2020 Proposed Rule that have been informed by, and more closely align with, recently stated objectives you described during a congressional hearing, a statement issued by the Financial Stability Oversight Council (the "Council"), and remarks made by you and other Council members during its latest meeting. RAA is a national trade association representing reinsurance companies doing business in the United States. RAA membership is diverse, including reinsurance underwriters and intermediaries licensed in the U.S. and those that conduct business on a cross-border basis.

First, thank you for your commitment to transition Fannie Mae and Freddie Mac (collectively the "Enterprises") from conservatorship in a safe and sound manner that protects U.S. taxpayers, and increases the quantity and quality of capital supporting them. Establishing a robust capital framework that is appropriate today but also structurally sound enough to maintain prudent Enterprise capital levels over time is a crucial step in making this transition. The Council's September 25 "Statement on Activities-Based Review of Secondary Mortgage Market Activities" statement provided a positive review and assessment of the 2020 Proposed Rule. RAA and our members greatly appreciate the Council's statement and your and FHFA's efforts.

Second, thank you for expressing support for credit risk transfer (CRT) during the September 16, 2020, U.S. House Financial Services Committee hearing. RAA and our members agree with FHFA that CRT constitutes an important source of private capital for the Enterprises and is a useful component of their risk management structure, supporting their ability to fulfill their mission across economic cycles. Further, RAA appreciates the observation that you made, during the

hearing, that CRT should neither receive dollar for dollar nor zero capital credit. Determining the right balance between those two points is the key question, and RAA is concerned that the 2020 Proposed Rule, as presently constituted, sets the line too close to zero credit, disincentivizing the Enterprises' utilization of CRT, which would as proposed, sacrifice important taxpayer and equity protection as well as independent, private capital perspectives on the risks that the Enterprises take.

Third, in addition to the above-mentioned remarks and statement, RAA also has reviewed other comments filed on the 2020 Proposed Rule. In considering these perspectives, RAA offers two suggested modifications that, together, would enhance the 2020 Proposed Rule while preserving the Enterprises' incentives to continue their use of risk transfer mechanisms, such as CRT and in a way consistent with those perspectives. RAA believes that changes to both the Leverage Ratio and Tranche Risk Weight Floor in the risk-based capital requirements must be made to accomplish this.

SUGGESTED MODIFICATIONS

Leverage Ratio

RAA agrees that the Leverage Ratio should provide a meaningful backstop to a well-calibrated, risk-based capital regime. The 2020 Proposed Rule includes both a 2.5% base leverage ratio, and a 1.5% prescribed leverage buffer amount (PLBA). The result is a combined leverage capital requirement that is now and often would be the binding constraint. As RAA and our member companies expressed in the responses to the 2020 Proposed Rule, CRT is given zero credit within the Leverage Ratio, which therefore disincentivizes the Enterprises from utilizing these structures when the Leverage Ratio is binding. The combined effect would be to incent the enterprises to increase risk-taking and accumulate those risks on balance sheet and suspend any effort to shed them to independent sources of private capital. To remedy this, RAA suggests that the 2020 Proposed Rule be amended to allow credit for CRT when calculating common equity tier 1 (CET1) capital to satisfy the PLBA.

For sake of clarity, RAA broadly supports the 2.5% value as a credible backstop to the risk-based capital requirements and is not proposing the inclusion of credit for CRT within the base Leverage Ratio, only the PLBA. RAA's view is that the magnitude of credit within the PLBA should be consistent with the magnitude of credit the Enterprises receive for CRT within the risk-based capital requirements. This symmetry will create the benefits of consistent CRT treatment regardless of which framework is the binding constraint and enable the Enterprises to enter into multi-year CRT contracts with greater certainty and confidence in their future capital treatment. It also will help preserve an ecosystem of reliable, private market investors in mortgage credit risk, maintaining private market capacity supporting the US mortgage market, and improving overall surveillance of market conditions.

Tranche Risk Weight Floor

RAA recommends that FHFA eliminate the 10% Tranche Risk Weight Floor for retained risk on CRT pools. The introduction of this Tranche Risk Weight Floor results in counterproductive and inefficient requirements on the Enterprises to hold *more* total capital if they purchase CRT than if

they did not. For example, under the 2020 Proposed Rule, the Enterprises would be required to hold less capital if they purchased shorter duration CRT transactions that detached below stress loss levels than if they purchased long-term contracts that covered them up to or in-excess-of modeled stress loss. The acknowledged deviation from capital neutrality is not necessary since the conditions cited in banking regulatory regimes, where deviation is appropriate (layering of model risk and significant simplifying assumptions), do not exist.

The prescribed haircuts within the 2020 Proposed Rule account for timing, counterparty, and overall effectiveness risk and effectively address CRT's limitations relative to equity capital. If further adjustments, beyond these significant haircuts, are deemed necessary by FHFA to mitigate any potential residual model risk, RAA proposes adding a coverage buffer that would increase the detachment point of CRT tranches to further support risk management by reducing losses during periods of housing stress. Protecting and preserving equity during periods of stress by using high-quality and FHFA-approved CRT programs is one of the most effective methods to secure the Enterprises' ability to successfully navigate future housing downturns without the need for future taxpayer support.

CRT ENHANCES FHFA'S SUPERVISION OF THE ENTERPRISES

Excessive risk-taking by the Enterprises has long been a paramount concern of regulators. With the Enterprises exiting conservatorship, will come a renewed focus on shareholders and the potential for short-term interests and profit maximization to collide with the long-term principles of safety and soundness. Reinsurers, by contrast, are long-term, buy-and-hold investors in mortgage default risk for periods of up to 15 years. They bear the risk of financial loss in adverse outcomes and can lose many multiples of their upside premiums.

The RAA and its members believe the entry of well-capitalized (re)insurers is strategically important to the housing ecosystem, not just because they enhance the quantity and quality of capital, but also because of their intellectual capital investments to price and monitor emerging risks in the U.S. housing market. Professional reinsurers and other private CRT capital absorb losses during times of stress and provide a critical "second set of eyes", but to be most effective, there must be a consistent and regular feedback loop, which is why it is important to continue to incentivize the use of CRT now and when the Enterprises exit conservatorship.

CONCLUSION

As set forth in our August 2020 comment letters to FHFA, RAA recognizes that the 2020 Proposed Rule has worthy objectives but, as drafted, would effectively eliminate CRT, destroying CRT's ability to enhance equity capital and limit taxpayer exposure to catastrophic mortgage credit losses. CRT is a valuable component of the Enterprises exiting conservatorship and post-conservatorship because:

- CRT works today to transfer risk to the private sector and can be a valuable bridge to recapitalization of the Enterprises;
- CRT protects taxpayers from the Enterprises' core mortgage credit risk;

- CRT will create a more diverse capital base that is resilient to stress, increasing certainty and furthering stability across the economic cycle;
- CRT improves housing affordability by lowering costs to homeowners and renters through a lower cost of capital (compared to equity capital);
- CRT brings a more diverse range, and larger pools of loss-absorbing capital to support the Enterprises; and
- CRT provides valuable feedback to the Enterprises on credit costs and underwriting standards.

RAA believes that as presently constituted the 2020 Proposed Rule sets the line too close to zero credit and threatens the ongoing incentives for the Enterprises' to utilize CRT, potentially sacrificing the loss reducing and real time credit perspectives that these transactions provide through the economic cycle. As a result, RAA strongly believes that the 2020 Proposed Rule should be modified, as outlined above, to provide robust incentives for the Enterprises to continue to use CRT as an essential risk management tool.

Thank you for the opportunity to provide additional comments. RAA would be happy to brief you regarding the recommendations in this letter or answer any questions you may have.

Sincerely,

Frank Nutter
President