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

Attention: Comments/RIN 2590-AB17
Amendments to the Enterprise Regulatory Capital Framework Rule

Dear Mr. Jones:

The Community Home Lenders Association (CHLA)[1] appreciates this opportunity to provide comments on FHFA's proposed amendments to the Enterprise Regulatory Capital Framework (ERCF) rule for Fannie Mae and Freddie Mac (the Enterprises).

CHLA supports FHFA's intent to refine the leverage buffer and the risk-based capital treatment for the Enterprises' credit risk transfer (CRT) activities. We share the views of many commenters that the leverage buffer in the current ERCF rule is excessively high relative to the risks of the Enterprises' businesses. It also is higher than the capital required under the risk-based standard, which requires the Enterprises to manage to a non-risk-based capital level and could encourage riskier behavior. Complying with the current leverage buffer would force the Enterprises to increase guarantee fees and loan level price adjustments (LLPAs) and/or tighten their credit standards. This would increase the cost and reduce the availability of home mortgage credit to homebuyers and homeowners. Additionally, we believe the ERCF fails to provide appropriate capital credit for the significant reduction in risk to the Enterprises from their CRT activities, to the point that it discourages CRT and incents the Enterprises to revert to the pre-conservatorship business model of holding onto credit risk.

The amendments help address these flaws in the current rule, although our understanding is that even with these changes, the Enterprises will still be required to hold an amount of capital well above what is needed to protect against the risks they face. CHLA thus urges FHFA to consider additional refinements to the ERCF rule to ensure the Enterprises' capital requirements strike the appropriate balance between ensuring their safety and soundness and enabling them to fully perform their mission.

[1] CHLA is the only national trade association exclusively representing small and midsized independent mortgage banks (IMBs) — community-based lenders whose sole business is originating and servicing home mortgage loans. More information about CHLA is available at communitylender.org.

Sufficient capital is necessary for the Enterprises to fully perform their mission, even if they remain in conservatorship

Possessing sufficient capital to absorb losses is necessary to ensure both the Enterprises ' financial safety and soundness and their ability to provide consistent liquidity and support to the market throughout all points of the housing market and economic cycles. It also is critical to enabling the Enterprises to meet their affordable housing and Duty to Serve obligations, and to support the Administration's policy objective of increasing housing equity. Recapitalization of the Enterprises thus is an important objective in and of itself, regardless of whether or when policymakers decide to transition the Enterprises out of conservatorship.

For these reasons, CHLA was one of the very first national organizations to propose ending the arbitrary and ill-conceived net worth sweep. We understood that if the Enterprises were perpetually worried about the reputational risks of taking even a small quarterly Treasury capital draw because they were not allowed to retain capital, they could set inappropriately conservative underwriting standards or overcharge for loans, just to avoid this risk.

This concern was clearly demonstrated in 2020 when FHFA and the Enterprises felt compelled to impose a 50 basis point "adverse market fee" on certain loans sold to the Enterprises to defray expected credit losses from the Covid pandemic. Had the Enterprises been allowed to build a sufficient capital cushion in prior years, they would have been able to ride out last year's turmoil without raising prices.

CHLA thus commends FHFA and Treasury for ending the sweep in the January 2021 revisions to the Preferred Stock Purchase Agreements (PSPAs) and requiring the GSEs to rebuild capital sufficient to comply with regulatory requirements.

Excessive capital requirements on the Enterprises needlessly increase the cost of and reduce access to mortgage credit

A principal critique of the ERCF rule is that it imposes excessive capital requirements on the Enterprises — $283 billion based on the June 2020 book of business, more than $100 billion beyond what they need, according to some commenters. CHLA does not presume to know the precise level of capitalization the Enterprises should have. However, we note that this capital requirement is strikingly inconsistent with the results of the annual stress tests conducted on the Enterprises by FHFA. These tests are mandated by the Dodd-Frank Act and determine the financial impacts on the Enterprises under a "severely adverse" scenario created by the Federal Reserve in which house prices and home equity significantly decline, unemployment rises sharply, and the economy is in a serious recession.

FHFA's most recent stress tests show that the Enterprises together would have lost $29.1 billion in 2019 and $11 billion in 2020.[2] The capital requirement thus is nearly 10 times the projected 2019 losses and more than 25 times the projected losses in 2020, suggesting the current ERCF requirements are excessive.

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[2] These losses assume the Enterprises are required under accounting rules to write down the value of their deferred tax assets (DTA) as part of the stress test scenario. Under a more favorable assumption with no DTA write down, the Enterprises would have lost only $7.18 billion in 2019 and would have made a profit of $10.8 billion in 2020 under the severely adverse scenario.

Under extended conservatorship with no end in sight, the Enterprises are highly unlikely to raise capital through equity offerings. They have to rely upon retained earnings to build the necessary capital, and based on their recent earnings history, it could require a decade for them to achieve compliance. The Enterprises thus have little choice other than to raise g-fees and LLPAs and tighten their credit boxes to build capital faster. This, of course, would increase the cost of and reduce access to mortgage credit, directly conflicting with both the Enterprises' mission purposes of providing liquidity and stability to the mortgage market and the policy goal of expanding their purchases of loans supporting affordable homeownership and rental housing for lower income, minority and other underserved borrowers.

The leverage buffer will be set at a more appropriate level, but overall capital requirements appear to remain too high

CHLA supports FHFA's proposed recalibration of the leverage buffer, which would address one of the most significant flaws in the ERCF. Under standard financial regulation, capital requirements for a financial institution are based on the risks of the institution's assets. A leverage buffer is set as a straight percentage of an institution's assets, regardless of the risks of those assets, and is designed to provide a backstop to the risk-based requirements.

However, under the ERCF, the leverage buffer is set higher than the risk-based standard, making the buffer the binding capital requirement. This requires the Enterprises to manage to a non-risk-based standard and reduces incentives to transfer and reduce risk. In fact, it incents the Enterprises to obtain higher risk assets offering higher returns to more quickly build capital.

The proposed changes to the leverage buffer would reduce its size by $74 billion and properly make the risk-based requirement binding. Our understanding is that based on the Enterprises' current books of business, the actual reduction in the capital requirement will be roughly one-half of the reduction in the buffer. This suggests a modest reduction in the Enterprises' capital requirements, at best — a welcome change, but leaving in place overly stringent requirements that, as noted, will force the Enterprises to raise prices and shrink their credit boxes to comply. We urge FHFA to consider additional refinements to the ERCF to strike an appropriate balance between safety and soundness and mission fulfillment.

Capital requirements should encourage the use of CRT by the Enterprises

The Enterprises' development of viable and effective CRT programs is one of the principal accomplishments of the conservatorships. Prior to conservatorship, the Enterprises concentrated significant amounts of credit risk in their guarantee portfolios, making them a major risk to the financial system and ultimately leading to their placement into conservatorship in 2008. Under their CRT programs, the Enterprises today transfer most of their first loss credit risk to other investors and have reduced their risk to a degree inconceivable a decade ago.

FHFA's annual stress demonstrate the extent of this risk reduction. In 2013, the first year in which the Enterprises were stress tested, they would have lost a combined $195.8 billion. Loss estimates have consistently declined in every annual stress test since then, culminating in a combined estimated loss of $11 billion in 2020 — a 94 percent reduction from 2013. While not solely attributable to CRT, these results attest to the remarkable success of the Enterprises' CRT programs.

This significant reduction in risk should be reflected in reduced capital requirements for the Enterprises. The current ERCF fails to do so, to the point that, as many commenters have persuasively argued, it strongly discourages the use of CRT by making transactions uneconomic. It thus was no surprise that Fannie Mae in response ceased doing CRT transactions for a time. A capital standard that discourages the transfer of risk away from the Enterprises — and taxpayers — makes no sense. We commend FHFA for recognizing this problem and proposing a solution.

We leave to more knowledgeable commenters whether the revisions proposed by FHFA are sufficient. But we strongly endorse the principle that quantifiable reductions in risk to the Enterprises from their CRT programs should be explicitly encouraged by FHFA policy and fully recognized in the capital standards for the Enterprises.

We also reiterate our longstanding opposition to legislative or regulatory mandates on the Enterprises to concentrate their CRT activities on "front-end" risk sharing or transfer. Such mandates provide an opportunity for large, vertically integrated Wall Street banks to originate and securitize mortgages in upfront risk sharing deals. This would enable Wall Street domination of the market, placing small and midsized lenders at a significant disadvantage. A better approach is to encourage greater use of "back-end" risk sharing by the Enterprises, which would both ensure equal access to and greater competition in the origination market, while dispersing the Enterprises' credit risk among a larger and more diverse group of private market investors.

Front-end risk sharing or transfer certainly plays a role in the Enterprises' CRT efforts and is done readily through placing private mortgage insurance (PMI) coverage on higher loan to value ratio mortgages sold to the Enterprises. However, the treatment of CRT under the current ERCF encourages overreliance on PMI, which presents two concerns.

First, large lenders are receiving volume discounts from PMI companies on mortgage insurance coverage of loans sold to the Enterprises. This provides a proxy for volume discounts on g-fees the Enterprises gave to large lenders prior to conservatorship, a practice that unfairly placed small and midsized lenders at a significant disadvantage in the origination market. FHFA commendably banned this practice early in the conservatorship, and this ban was codified in the January 2021 PSPA revisions. FHFA likewise should forbid Enterprise purchases of mortgages with volume-discounted MI coverage.

Second, we believe FHFA should allow the Enterprises to directly place MI coverage on mortgages they purchase. Under current practice, lenders place coverage on such loans. This prevents the Enterprises from managing the substantial counterparty risks of MI coverage. Allowing the Enterprises to directly place coverage would enable them to manage and mitigate these risks, under FHFA supervision. Direct placement also would relieve lenders of a major source of repurchase risk by removing their obligation to place and maintain MI coverage on high LTV ratio loans. Finally, by reducing sales and marketing costs that are a significant part of the cost structure of traditional monoline PMI companies, direct placement could save borrowers up to 30 percent on MI premiums, increasing affordability for low and moderate income, minority and other underserved borrowers.

We again thank FHFA for the opportunity to comment on its proposed amendments to the ERCF. Please do not hesitate to contact us if you need further information or if we may be of assistance.

Sincerely,

COMMUNITY HOME LENDERS ASSOCIATION