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February 25, 2022

By Electronic Delivery Through the FHFA Website

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

Re: Comments/RIN 2590-AB16 – Proposed Rule on Capital Planning and Stress Capital Buffer Determination

Dear Mr. Jones:

Freddie Mac is pleased to submit our enclosed comments on the Federal Housing Finance Agency's proposed rule on capital planning and stress capital buffer determination. Freddie Mac appreciates the opportunity to provide our views on the proposed rule. Please do not hesitate to contact me if you have any questions.

Sincerely,

Enclosure

Freddie Mac

Comments on the Proposed Rule on Capital Planning and Stress Capital Buffer Determination

February 25, 2022

Freddie Mac appreciates the opportunity to provide comments on FHFA's notice of proposed rulemaking on Capital Planning and Stress Capital Buffer Determination (the "Proposal").[1] The Proposal would require Freddie Mac and Fannie Mae (the "Enterprises") to submit annual capital plans to FHFA and provide prior notice for certain capital actions.[2] The Proposal would also incorporate the determination of the stress capital buffer ("SCB"), which is an element of the Enterprise Regulatory Capital Framework ("ERCF"), into the capital planning process.[3] FHFA notes that the requirements in the Proposal are broadly consistent with the regulatory framework for capital planning for large bank holding companies.[4]

In general, Freddie Mac is very supportive of the capital planning and SCB processes that would be required by the Proposal. Notwithstanding this overall support and consistent with our position in previous comment letters, we recommend that FHFA modify the required calculation of the SCB by removing the 0.75 percent floor, adopting a measure based on Freddie Mac's stress-testing performance, removing the pre-funded dividend component to the SCB given that the Enterprise will not be distributing dividends in the near future, and holding assets used to calculate the SCB constant throughout the forecasted stress horizon. We also recommend that FHFA clarify an official compliance date for the final rule so that the Enterprises have sufficient time to prepare their first capital plan submissions under the guidance of the final rule.[5]

I. FHFA Should Modify and Enhance the SCB by Removing the Buffer Floor of 0.75 percent of Adjusted Total Assets, Adopting at this Time an SCB Measure Based on the Enterprise's Stress Testing Performance, Removing the Dividend Add-on Assumption within the SCB, and Holding the Balance Sheet Used to Calculate the SCB Constant Throughout the Projected Stress Horizon

[1] *See* FHFA, Capital Planning and Stress Capital Buffer Determination, 86 Fed. Reg. 73187 (Dec. 27, 2021).
[2] *See* Proposed 12 CFR 1240.500(d) and (g).
[3] *See* Proposed 12 CFR 1240.500(e) and (g).
[4] *See* 86 Fed. Reg. at 73187.
[5] We note that the Proposal also would require the Board of Directors (Board) (or a designated committee thereof) to perform certain functions, including reviewing the robustness of Freddie Mac's process for assessing capital adequacy, ensuring that any deficiencies in the process for assessing capital adequacy are remediated, and approving the capital plan before submission. *See* Proposed 12 CFR 1240.500(d)(iii). We are concerned that the use of the term "ensure" when referring to the role of the Board could suggest that the Board has more than an oversight role for certain actions and steps that are properly the responsibility of management. We recommend that FHFA revise the Proposal to replace the term "ensure" with language focused on oversight, such as "oversee" or "review."

The Proposal would incorporate the determination of the SCB into the capital planning process. As under the existing ERCF, the SCB would be determined by FHFA,[6] and the calculation would be based on the results of a supervisory stress test, subject to a floor of 0.75 percent of the Enterprise's adjusted total assets ("ATA").[7] In addition, as also specified in the existing ERCF, the buffer would be equal to 0.75 percent of ATA as of the last day of the previous calendar quarter, until such time as FHFA develops its supervisory stress test or in any year that FHFA does not determine the SCB.[8]

We recommend that FHFA make four revisions to the proposed SCB determination: (1) removing the 0.75 percent floor; (2) adopting a measure based on stress-testing performance; (3) removing the pre-funded dividend add-on (the sum of the Enterprise's planned common stock dividends for each of the fourth through seventh quarters of the planning horizon); and (4) holding either ATA or risk-weighted assets ("RWA") constant throughout the stress horizon for the purpose of calculating the SCB. We recommended certain of these revisions in our November 24, 2021 comment letter in response to FHFA's proposed amendments to the ERCF relating to the Prescribed Leverage Buffer Amount and Credit Risk Transfer ("November 2021 Comments").[9] We have since updated and expanded upon certain arguments from our November 2021 Comments per below.

First, we believe that FHFA should remove the floor of 0.75 percent of ATA, because such a floor is inappropriate for the Enterprises. The stress capital buffer used by U.S. bank regulators applies to many different types of institutions, many of which have significant variations in business types and risk profiles. As the Federal Reserve has noted, "Placing a 2.5 percent of risk weighted assets floor on the stress capital buffer requirement would ensure a minimum level of stringency across firms of all sizes and complexity and that a smaller firm would not be subject to more [of] a stringent buffer requirement than a firm with total consolidated assets of $50 billion or more."[10] For banks, a static SCB floor of 2.5 percent of RWA addresses concerns that larger institutions could utilize a dynamic stress buffer based on stress testing results to lower their capital requirements relative to smaller peers, absent the floor. However, the Enterprises do not have a subset of smaller competitors that would be harmed by the Enterprises managing toward a low SCB.

The Federal Reserve appeared concerned that a floor would blunt the desired risk sensitivity of the dynamic stress capital buffer and evaluated the risk sensitivity in a staff memo supporting the final rule. In adopting its SCB, the Federal Reserve discussed the risk sensitivity of its final rule, noting that roughly half of the target population would be above the floor,[11] meaning that for the population above the floor, the new rule would create a risk-sensitive buffer. Freddie Mac believes that based on recent supervisory stress test results, our SCB would be generally below the 0.75 percent floor (particularly as the floor also contemplates the concept of a dividend add-on, as we describe in greater detail below), thereby blunting the risk sensitivity of the measure and potentially increasing risk-taking if the Enterprise manages toward the floor.

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[6] Proposed 12 CFR 1240.500(e)(1).

[7] Proposed 12 CFR 1240.500(e)(2). The Proposal would modify the existing formula for determining the SCB by considering an Enterprise's planned common stock dividends for the fourth through seventh quarters of the planning horizon rather than the current ERCF direction to use each of the nine quarters of the planning horizon. *See* 86 Fed. Reg. at 73190.

[8] Proposed 12 CFR 1240.500(e)(2); 86 Fed. Reg. 73190.

[9] *See* Letter from Christion Lown to Clinton Jones at 16-19 (Nov. 24, 2021).

[10] 83 Fed. Reg. 18160, 18165 (Apr. 25, 2018) (preamble to Board of Governors of the Federal Reserve System, Notice of Proposed Rulemaking on Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules).

[11] 85 Fed. Reg. 15576, 15590 (Mar. 18, 2020) (preamble to Board of Governors of the Federal Reserve System, Final Rule on Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules).

Second, replacing the proposed requirement with our recommended, dynamic calibration of the SCB anchored on stress testing would provide an additional supervisory tool to FHFA and ensure a diversity of approaches to setting capital that would address any unintended consequences of overreliance on one metric through the variability of the credit cycle. In addition, our recommended calculation of the SCB could be applied now, rather than waiting for the further development of FHFA's supervisory stress test.[12] Our approach would operate as follows:

- Apply the Dodd-Frank Act Stress Test ("DFAST") severely adverse scenario in order to reflect an SCB capital requirement that is more stress-test based;
- Use the severely adverse scenario without Deferred Tax Asset ("DTA") write off;
- Over the nine-quarter stress horizon, observe the quarter with the largest cumulative losses; and
- Consistent with the 2020 Federal Reserve Rule on SCBs for banks, apply a constant balance sheet assumption which would ensure simplicity to the supervisory stress testing framework overall, while also precluding the likelihood of a reduction in credit supply in a stress scenario

We recommend using the severely adverse scenario without DTA write off instead of with DTA write off for the SCB calculation and future stress testing results submission as Freddie Mac's stress losses have significantly declined since 2013 and the Enterprise's earnings have been meaningfully stronger in recent years. We believe that this treatment is generally more aligned with the state of the Enterprises today as a DTA valuation allowance would less likely be established in a severe stress scenario.[13]

In consideration of on-going DFAST exercises and the greater alignment of DFAST and stress testing more broadly with capital planning, we strongly recommend that FHFA replace the existing SCB with a measure based on an Enterprise's stress testing performance (specifically, its peak-to-trough impact as exhibited under its annual nine quarter forecasted results), without the application of the 0.75 percent floor. Switching to this more risk-sensitive and dynamic measure would still permit FHFA to realize the benefits of an SCB, while providing for additional calibration, countercyclicality (through the scenarios of the stress tests) and appropriate tailoring. The exposure that FHFA is trying to manage is highly risk sensitive, and this recommended SCB approach would reflect that particular element of risk sensitivity.

For comparison purposes, the following **Table 1** provides a breakdown of the eight Globally Systemically Important Banks ("G-SIBs"), which showcases the interplay between the G-SIB's peak to trough CET1 impact (*i.e.*, the "stress impact"), cumulative stress losses, resulting SCB (in dollar terms), implied pre-funded four-quarter dividend amount (the difference between the SCB and the Stress Cumulative Losses), as well as individual entity's Risk Density for comparison. Generally speaking, Freddie Mac has a much lower risk profile relative to the Enterprise's G-SIB peers – as evidenced by Freddie Mac's lower risk density (which ranges between 25% to 30%)[14] relative to G-SIBs (which averages

[12] The current Capital Planning and Stress Capital Buffer Determination NPR notes that "until such time as the Agency develops its supervisory stress test […]," which would indicate that FHFA is in the process further contemplating potential developments to its supervisory DFAST exercise overall.

[13] Prior to the Conservatorship, for example, the Enterprise had a large DTA balance (approximately $15 billion as of 2008) that needed to be written off during the crisis. While this treatment was appropriate at the time, we believe that it set the precedent for inclusion of DTA valuation as part of the stress testing process that is no longer appropriately tailored given the size of our DTA (approximately $6 billion as of 4Q2021) which has decreased by more than 60%, particularly given our improved risk profile and loan portfolio over time.

~50%) as well as Freddie Mac's 2021 DFAST exercise which generates a stress impact[15] that is generally lower than the eight G-SIBs.

In addition to Freddie Mac's portfolio being generally less risky relative to G-SIBs' portfolios, the current FHFA SCB floor (consistent with the Federal Reserve Board's SCB rule) contemplates a pre-funded dividend add-on which is applicable for the fourth through seventh quarter of the capital planning horizon (consistent with the Federal Reserve's SCB rule) – see **Figure 1** below for a breakout of the Stress Capital Buffer requirements. It is very important to note that this implied pre-funded dividend add-on and forecasted dividend pay-out is not currently applicable to the Enterprises (and may not be for a considerable period of time), given the nature of the Enterprises' capital level and position. Moreover, the dividend add-on leveraging the existing SCB requirement structure applicable to banks (as of the latest 2021 DFAST cycle the four quarter pre-funded dividends for G-SIBs range from approximately $2 billion to $12 billion, per Table 1 below) is quite sizable for G-SIBs and even more sizable to Freddie Mac, given that the Enterprise's peak to trough stress results are generally lower than G-SIBs based on the aforementioned details regarding Freddie Mac's lower risk density and historical stress test losses. Thus, the amount of the implied dividend for the Enterprise is quite significant relative to the overall size of the prescribed SCB for Freddie Mac,[16] which we believe is not appropriate given that the Enterprises do not currently distribute any dividends and are not forecasted to distribute dividends in the near future.

Table 1: Comparison of Freddie Mac's Stress Capital Buffer relative to G-SIBs

Stress Capital Buffer ("SCB") Impact and G-SIB Peer Assessment						
	Stress impact %	SCB (RWA)%	Stress Cumulative Loss ($)	SCB ($)	Implied Dividend ($)	Risk Density
Bank of America	2.00%	2.50%	30.2	37.0	6.83	0.53
Bank of New York Mellon	1.00%	2.50%	1.6	4.1	2.54	0.54
Citigroup	2.70%	3.00%	32.4	36.3	3.86	0.51
Goldman Sachs Group	5.90%	6.40%	32.9	35.5	2.59	0.42
JPMorgan Chase	2.40%	3.20%	38.1	49.9	11.85	0.46
Morgan Stanley	4.70%	5.70%	21.1	25.8	4.72	0.38
State Street	0.90%	2.50%	1.0	2.9	1.90	0.57
Wells Fargo	2.80%	3.10%	33.2	36.6	3.32	0.61
G-SIB Average	**2.80%**	**3.50%**	**23.8**	**28.5**	**4.70**	**0.50**

All comparison against the eight G-SIBs are referenced using Federal Reserve's August 2021 DFAST Stress Test publication (utilizing 4Q20 as jump-off)

- *The "Stress Impact %" is calculated as the difference between the CET1 ratios btw 4Q20 jump-off ("peak") to the minimum point ("trough") over the stress horizon*
- *The "SCB (RWA)%" is taken from the table within Federal Reserve's August 2021 Dodd-Frank Act Stress Test Publication link (which contains bank-specific SCB, effective October 1, 2021)*
- *All calculations are performed using 4Q20 RWA for G-SIBs – leveraging both the available data source per the above as well as disclosures per the FR Y-9C*

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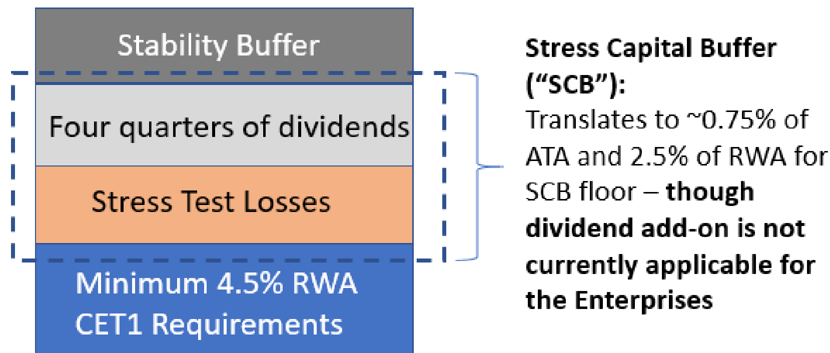
[14] Estimated numbers are as of 2Q20 based on publicly disclosed analysis per the Enterprise Regulatory Capital Framework Final Rule published on December 17, 2020. Estimates range between the re-proposed rule as well as the final rule. Note that overall the risk profile of the Enterprise has improved since that time, particularly given the recent revisions to the ERCF rule amendments as published in September 2021.

[15] *See* Freddie's Mac's 2021 public DFAST disclosure "dodd_frank_stress_test_results2021.pdf (freddiemac.com)."

[16] Note that the Stress Capital Buffer for Freddie Mac was $21 billion as of 3Q20, following the initial publication of the ERCF capital rule (Fact Sheet: Final Rule on Enterprise Capital (fhfa.gov)), and has steadily increased as the Enterprise's balance sheet continues to grow.

Figure 1: Enterprises' Capital Buffer Requirement



Finally, Freddie Mac believes that the Enterprise's balance sheet should be held constant throughout the forecasting horizon, similar to the Federal Reserve's 2020 SCB Rule and as reflected within the Federal Reserve Board's Stress Testing Policy Statement. This change would align FHFA's SCB framework with the Federal Reserve's SCB rule adopted in 2020.[17] In adopting its SCB per "Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules," the Federal Reserve noted that keeping the balance sheet constant both simplifies the framework, as well as dissuades firms from planning to reduce credit supply under a severely stress scenario, which is a more realistic supervisory projection.[18] The Federal Reserve also noted in the 2021 DFAST results that, for simplicity sake, the Federal Reserve Board assumed a firm's RWAs and leverage ratio denominators remained unchanged over the projection horizon except for changes primarily related to items subject to deductions from regulatory capital or due to changes to the Federal Reserve Board's regulations.[19] The Enterprises would similarly benefit from a parallel approach adopted by FHFA (which would hold both leverage and RWA constant, consistent with the Federal Reserve Board's balance projections and calculation of regulatory capital ratios for 2021 DFAST). As noted, this methodology would be simpler overall and help dissuade procyclical credit supply contraction.

II. FHFA Should Clarify a Compliance Date That Allows Sufficient Time to Prepare a Capital Plan Before the Submission Date of May 20

The Proposal would require each Enterprise to submit a capital plan each year by May 20. The capital plan would be required to contain extensive information, including such elements as: (1) an assessment of the expected uses and sources of capital over the planning horizon; (2) a detailed description

[17] 85 Fed. Reg. at 15579.
[18] 85 Fed. Reg. at 15580.
[19] *See* Dodd-Frank Act Stress Test 2021: Supervisory Stress Test Results at p.16 (June 2021).

of the Enterprise's process for assessing capital adequacy; (3) the Enterprise's capital policy; and (4) a discussion of any expected changes to the Enterprise's business plan that are likely to have a material impact on capital adequacy or liquidity.[20]

The Proposal does not make clear the effective date of any final rule. Because the comment deadline is February 25, 2022, it is possible that the Proposal could be finalized with only a short amount of time before what would be the first submission date of May 20, 2022. Accordingly, we recommend that FHFA clarify that it will provide the Enterprises with at least six months from finalization of this rule before the first capital plan will be due, or that it will schedule the first capital plan submission on May 20, 2023.

[20] Proposed 12 CFR 1240.500(d)(2).