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Alfred M. Pollard, General Counsel
Federal Housing Finance Agency, Fourth Floor
1700 G Street NW
Washington, DC 20552

Attention: **Comments/ RIN 2590-AA40**
Alternatives to Use of Credit Ratings in Regulations Governing the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Federal Home Loan Banks

Dear Mr. Pollard:

Fannie Mae appreciates the opportunity to submit comments in response to the Advance Notice of Proposed Rulemaking, published on January 31, 2011[1] ("ANPR"), addressing alternatives to the use of credit ratings issued by nationally recognized statistical rating organizations ("NRSROs") in Federal Housing Finance Agency ("FHFA") regulations governing Fannie Mae and Freddie Mac (the "Enterprises") and the Federal Home Loan Banks (the "Banks").

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requires Federal agencies to (i) review existing regulations that require the use of an assessment of the creditworthiness of a security or money market instrument; and (ii) remove any references to credit ratings from those creditworthiness standards and establish their own creditworthiness standards.[2]

Fannie Mae acknowledges FHFA's obligation to make appropriate changes to the relevant regulations. Fannie Mae supports FHFA's efforts to make certain that these changes further its regulatory role to ensure that the Enterprises and Banks operate in a safe and sound manner and that their activities foster liquid, efficient, competitive and resilient national housing finance markets, carrying out their public policy missions through authorized activities.

I. <u>General Comments</u>

FHFA has identified two categories of Enterprise regulations potentially affected by Dodd-Frank: (1) risk based capital ("RBC") requirements based on NRSRO ratings[3], and (2) prudential standards for non-mortgage liquidity investments.[4] Fannie Mae suggests that FHFA can take immediate steps to address the requirements of Dodd-Frank, while considering options for developing future RBC and prudential standards.

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[1] 76 Fed Reg. 5292 (January 31, 2001).
[2] Public Law 111-203, 124 Stat. 1887 (July 21, 2010).
[3] 12 CFR Part 1750.10 *et seq.*
[4] 12 CFR part 1720, App. B §§ (C)(3)(c)(i) and (D)(1).

Removal of References to NRSROs

As described in the ANPR, existing statutory and FHFA directed regulatory capital requirements are not binding on the Enterprises during conservatorship.[5] Consequently, Fannie Mae suggests that, as FHFA considers alternatives, the NRSRO references contained within the RBC requirements can be deleted immediately without impairing FHFA's ability to monitor and promote the safe and sound operations of the Enterprises. Likewise, FHFA notes that current prudential standards, though referencing NRSRO ratings, do not necessarily require the Enterprises to take or refrain from any actions based on those ratings.[6] As with the RBC requirements, Fannie Mae suggests that the reference to NRSRO ratings can be deleted without formulating an immediate replacement.

Future Use of NRSRO ratings

Dodd-Frank's ban on references to NRSRO ratings in federal agency regulations does not purport to prohibit or limit the use of these ratings by regulated entities. While we acknowledge certain limitations among the NRSRO ratings, Fannie Mae believes that these ratings represent a source of meaningful public information and that any future regulations should not preclude their continued use as an input, where appropriate. As Acting Comptroller of the Currency John Walsh said in testimony prepared for a Senate hearing on February 17, 2011: "With appropriate operational and due diligence requirements, credit ratings can be a valuable factor to consider when evaluating the creditworthiness of money market instruments and other securities."

Future Model-Based RBC and Prudential Standards

The current RBC rule uses NRSRO ratings in the Counterparty Default component, which measures credit losses against 1) credit enhancement counterparties, 2) derivative counterparties, and 3) a variety of investments such as corporate, municipal, and some mortgage assets. The ANPR and Fannie Mae's comments, do not address losses on mortgage asset investments and guarantees, which are measured outside the Counterparty Default component using FHFA's mortgage performance model.

In considering the replacement of NRSRO ratings in FHFA's RBC rules and prudential requirements, Fannie Mae has considered three broad possibilities:

- Replace NRSRO ratings with internal ratings.
- Replace NRSRO ratings with models developed either internally, by vendors, or by FHFA. These models could be managed internally or at FHFA.
- Replace NRSRO ratings with market indications, such as prices or spreads.

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[5] 76 Fed. Reg. at 5294.
[6] 76 Fed. Reg. at 5294. FHFA further notes that these provisions appear outside the scope of Dodd-Frank. *Id.* Fannie Mae agrees with FHFA's assessment on this point.

Based upon our review, we believe that replacing NRSRO ratings with models is the most prudent option in most instances. While models have limitations, they afford regulators the best opportunity to tie capital to risk. Fannie Mae supports FHFA's tradition of model-based capital assessment using computer simulations.

Fannie Mae believes that model-based approaches can be successful, so long as they strongly tie capital to risk and are operationally workable. Fannie Mae recommends that the Enterprises develop and manage internal models, subject to FHFA supervision under clear guidelines. Where exposures are smaller or methods are less evolved, FHFA could propose simpler approaches and allow the regulated entities to opt into more complex methods.

II. Comments on ANPR Questions

Provided below are Fannie Mae's comments on questions set forth in the ANPR. Where we do not have comments on a specific question or subsection of a question, such relevant question or subsection has been omitted.

Principles for a New Approach

In the ANPR, FHFA states that any new standard of creditworthiness should consider five principles.[7] FHFA follows this statement of principles with several questions, discussed below.

Question 1. ***What core principles would be most important in FHFA's development of new standards of creditworthiness? Are there principles in addition to those above that should be incorporated into new standards?***

Fannie Mae agrees with the principles outlined by FHFA and suggests considering four related principles: (i) the standards should require that capital be tied to risk, and levels of risk; (ii) the standards should be operationally workable; (iii) the standards should accommodate change; and (iv) to the extent possible, capital requirements should be similar to those applied to other regulated financial institutions. These principles are consistent with those presented by FHFA, but contain additional considerations.

(i) Tying Capital to Risk.

Capital requirements should be appropriately higher for greater risks and lower for lesser risks. This creates the proper incentives to manage risk.

This concept is similar to FHFA's principle of *distinguishing between credit risk levels* and includes the additional criterion that any standard should also associate those risks with appropriate capital levels. When capital requirements are closely tied to risk, institutions and industries are encouraged to engage in transactions that optimize their use of capital. When

[7] The five principles are as follow: (i) Distinguish between different levels of credit risk, in an accurate and meaningful manner; (ii) be a transparent approach; (iii) be able to be applied consistently across consistently regulated entities to the extent they are subject to the same regulatory requirements; (iv) be straightforward and not unduly burdensome to apply; and (v) not be readily subject to manipulation. 76 Fed Reg. at 5295.

capital is used optimally in proportion to risk, the goals of financial system safety and soundness and economic growth can be more evenly balanced.

Importantly, FHFA's goal that *credit standards should not be readily subject to manipulation* is a natural outcome of rules which closely tie capital to risk. If capital is appropriately assessed up and down the continuum of risk levels, there are few incentives or opportunities to engage in non-economic transactions that have a preferential capital treatment. Tying capital to risk naturally supports FHFA's goal of *consistency between commonly regulated entities*. Insofar as regulated entities have similar credit risk positions, rules that closely tie capital to credit risk will indicate similar capital requirements, but differences in risk will appropriately lead to different requirements.

(ii) Operational Workability

The regulated institutions must be able to incorporate the new standards into their business planning and the standards should reflect an appropriate balance of financial cost versus regulatory benefit. Unworkable standards could impair an entity's ability to manage risks and capital prudently and may increase the cost of compliance.

This principle expands on FHFA's goal that *credit risk rules should be straightforward and not unduly burdensome,* and further measures prospective rules against the need for the Enterprises to be able to plan and manage their businesses. FHFA's goal of *transparency* supports this broader goal in that the regulated entities can more easily employ simple, transparent rules. Fannie Mae advocates tying capital to risk and operational workability as its two highest goals.

In practice, harmonizing the goals of Operational Workability and Tying Capital to Risk requires compromise. One practical compromise, drawn from bank regulation, is to allow the Enterprises to use more simple approaches for assets that are small in exposure or limited in risk but use more advanced fully-modeled internal approaches for larger exposures and assets that reflect core business.

(iii) Accommodating Change

Regulations need to adapt to change. Our experience under the current RBC rules has shown us that a regulator can amend rule mechanics much more quickly when regulations contain pre-defined rules that address changing circumstances. Without these rules, significant delays can occur during which the goals of Tying Capital to Risk and Operational Workability are not fully served.

(iv) Similarity of Capital Requirements of other Financial Institution Regulators

Capital rules should provide for equity and competitiveness across financial institutions governed by different regulators.[8] Financial institutions should have broadly similar credit

[8] Section 939A of Dodd Frank directs that in developing substitute standards for determining creditworthiness, agencies should "to the extent feasible, adopt a uniform standard for use in its regulations, taking into account the entities regulated and the purposes for which those regulated entities would rely upon the credit-worthiness standard." Public Law 111-203, 124 Stat. 1887 (July 21, 2010).

capital requirements. Where separate financial institutions are regulated differently, an exact similarity in capital requirements cannot be maintained for the full spectrum of possible risk taking, but the similarity should be greatest where:

- the institutions have books of business that are similar and in the middle of the risk-taking spectrum;

- the books of business experience similar business conditions; and

- the institutions have similar relationships (subsidies or guarantees) with the government.

The broad similarity of capital requirements between regulators does not mandate that calculations and methods need to be similar, or that the sensitivity of the requirements should be identical. Indeed, where one set of regulations is more advanced than another in assessing capital it is not necessarily beneficial to simplify regulations for the sake of similarity.

Do differences in the business models, structures and core mission and activities of the Banks and the Enterprises justify or compel developing approaches that may emphasize different core principles depending on whether the rule applies to the Banks or the Enterprises?

The Enterprises and the Banks should be regulated under generally similar, model-based approaches. Given a model-based approach (using simulations maintained internally at the Enterprises or at FHFA), the Banks and the Enterprises will appropriately differ in capitalization according to differences in risk but employ common approaches.

In addition to the common incentive to leverage models as a best practice, the Enterprises and the Banks share similarities in business models that also favor a common regulatory approach.

Alternative Approaches for Risk Based Capital Requirements

<u>**Question 2**</u>. ***What types of objective criteria could be used to differentiate credit exposures and apply meaningful credit risk capital charges? Should different criteria be used for different broad classes of investments or exposures?***

Question two references a possible risk "bucket" approach, which would group risk positions according to "objective criteria" that describe either the investment positions or the counterparties. Fannie Mae does not recommend the use of risk buckets as they are less accurate in delineating credit risk exposures between and within each risk category. Fannie Mae recommends that objective criteria should be applied within a model-based approach.

FHFA can gather "objective criteria" as inputs into models that would replace existing ratings-based models, consistent with an overall model-based approach. These criteria may appropriately differ by class of exposure, depending on the drivers of behavior for each type of exposure. The objective criteria used in capital assessment should be substantially similar to those used in risk management. The criteria fall into two broad categories:

- *Modeling data.* This category of criteria includes drivers of prepayments, default, and loss severity, such as interest rates, and borrower credit profile. It also includes drivers of credit enhancement performance and measures of counterparty financial strength such as counterparty capital, liquidity and earnings.

- *Contractual terms of income and expense streams*, including credit enhancements. This category of criteria includes unpaid balances, maturity dates, coupons, fees, collateral requirements, and terms of any embedded options.

FHFA could also gather more complex "objective criteria" in the form of performance metrics which express measurements of the economic impact of different risk drivers on risk positions, but fall short of completely measuring required capital. Some examples include Probability of Default (PD) and Loss Given Default (LGD). These metrics can replace some or all of the underlying criteria described above as inputs into a performance model.

Could there be perverse incentives or other "downsides" to this approach? What might be the problems with this approach?

Introducing more complex modeling generally reduces Operational Workability, but can be justified as an improved method of Tying Capital to Risk. More complex models may also introduce model risk. However, the main credit risk at the Enterprises -- mortgage loans -- is already measured and managed using models, both at the Enterprises and at FHFA. The increased complexity of using models may increase the cost of regulation, through added data and systems requirements at the regulator, the regulated entities, or both. Increased complexity may also decrease transparency.

Using performance metrics as replacement ratings has the disadvantage of likely requiring a fully modeled approach to generate the performance metrics. If complex models are introduced, Tying Capital to Risk is better served by using the models to provide a continuum of capital assessments up and down the risk spectrum rather than grouping performance metrics into buckets and mapping those buckets to discrete ratings. An approach of creating buckets would not account for differences in riskiness among exposures that fall into the same category. Because of these disadvantages, we do not recommend this approach.

Question 3. ***What qualitative and quantitative standards would FHFA need to set to implement an approach that relied on the regulated entities to generate internal estimates of credit risk exposures?***

Fannie Mae suggests that internal estimates be measured against the following standards:

- Is staff appropriately skilled?

- Has the approach been adequately backtested?

- Are underlying assumptions reasonable?

- Is the approach consistent with market methods?

- Are the results benchmarked against market results?
- Is the approach appropriate through the economic cycle?
- Is governance in place for model usage and not just model creation?
- Is the process and its audit history documented?

What are the strengths and weaknesses of such an approach? What would be the strengths and weaknesses of having FHFA itself set credit risk capital charges based on its own estimates of risk?

Internal estimates generated by the Enterprises will tend to adapt more quickly to changes in the market or industry best practices, and save regulatory resources by eliminating the need for a regulator to build additional models. However, internal estimates may produce less uniform capital charges between the Enterprises due to differing methods, and possibly due to differing examination relationships. Additionally, internal estimates may experience less certainty in capital planning than would result from defined regulatory prescriptions, unless the guidelines and safe harbors for internal methods are very clearly defined by FHFA. However, we believe that these concerns are mitigated as a result of FHFA's existing examination relationships with each Enterprise.

Regulatory estimates generally have the opposite strengths and weaknesses of internal methods.

Question 4. ***In order to apply a meaningful risk-based capital charge, FHFA needs to set forth requirements for the regulated entities to estimate the credit risk of their various exposures. Could an approach be developed that estimates a meaningful risk-based capital charge that avoids requiring a specific credit risk charge or specifying criteria to estimate credit risk? What might such an approach be?***

Declines in market prices during stress events can provide the basis for capital charges, without needing to identify the portion of the price decline due to credit influences. However, FHFA should carefully consider where within its RBC rules market pricing is most appropriate. Market pricing is less relevant for assets that the Enterprise intends and is able to carry for a period long enough to recover from temporary price influences. Market pricing is also less relevant for liabilities. Because of the difficulty of attributing price changes to different types of risk drivers, it is difficult to ensure that other capital assessment mechanics (such as credit and interest rate risk) do not double count capital requirements.

For internal consistency, if FHFA uses asset price declines to establish capital charges, any concurrent asset gains should also be considered as reductions in required capital.

Alternative Approaches to Prudential Regulations

Question 5. ***What are the strengths and weaknesses of these various approaches? Are there any existing, objective tools or approaches that could readily replace references to ratings issued by NRSROs in the regulations discussed in this ANPR? Are there other approaches not discussed above that may be appropriate?***

As with new RBC standards, Fannie Mae recommends that FHFA consider internally developed approaches subject to FHFA supervision.

Additionally, third party vendors offer tools that estimate creditworthiness and most institutions will use similar corporate default rate transition matrices to project future default rates. Vendor-based products would require regulator approval and oversight of the models, suggesting a structure where regulations require institutions to regularly validate the models being used, but remain silent on whether the model is internal or third party. In our experience, few, if any, vendors support the complex but narrow business model of the Enterprises. Therefore, we do not recommend the replacement of existing references to ratings using third party vendor tools.

Question 9. ***What are some other safeguards or requirements (not necessarily based on creditworthiness standards) that might provide protections similar to those afforded under FHFA's current regulations that reference ratings issued by NRSROs?***

Notifications, limits, pre-approvals, and other prudential requirements are an important piece of risk management and governance and should be viewed as working in concert with risk-based capital assessments. With the presence of a robust risk-based capital rule there is less need for overly prescriptive prudential rules.

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Thank you for allowing us to present these comments. If you have questions regarding matters addressed herein, please feel free to contact the undersigned at 202-752-3394.

Sincerely,

Michael Shaw
Executive Vice President and Chief Credit Officer