Federal Housing Finance Agency
Eighth Floor, 400 Seventh Street, SW
Washington, DC 20219
Attention: Comments/RIN 2590-AA95
[via electronic submission]

Dear Sir or Madam:

The Structured Finance Association ("SFA") believes the Federal Housing Finance Agency's (the "FHFA") "Enterprise Regulatory Capital Framework", released for comment by the FHFA on May 20, 2020 (such re-proposed rule, the "ECF Re-Proposal") presupposes (or overlooks the need for) the resolution of threshold issues that need to be considered by the FHFA prior to the adoption of any Enterprise capital framework ("ECF"). The issues requiring resolution, whether in the form of the ECF Re-Proposal or otherwise, are critical not just for the two Enterprises, but for the broader system of housing services in the United States, an industry that, by some estimates, is the second-largest in the country and which represents about one-sixth of the nation's economy. We also believe that it is impossible to comment on capital in isolation without discussing whether there will be a reliable government role or not, given that the FHFA has repeatedly said that the goal is to release the Enterprises from Conservatorship.

I. Introduction

SFA is the trade association for the securitization industry in the United States. With over 370 member organizations, – including issuers, book-runners, institutional investors, credit rating agencies, law firms, trustees, advisory firms, analytics firms (including in particular, mortgage credit analytics), technology vendors and diligence firms – our diverse membership provides us a wide-ranging perspective on the securitization industry.

As you will see detailed in our letter, as the trade association representing the market practitioners who facilitate the investing and trading in all Enterprise securities, we believe it is impossible to release the Enterprises from Conservatorship in a manner consistent with their Charters absent clarity around the government's role. In fact, a system without such clarity is simply a return to reliance on the "implied guarantee" of the past to make that work. We believe this is a very dangerous approach.

We understand the desire to release the Enterprises from Conservatorship. Twelve years is a long time and likely not the timeframe the FHFA or Congress had envisioned maintaining the Conservatorship at its outset. However, it is important to note that the Housing and Economic Recovery Act of 2008 ("HERA") does not explicitly limit the amount of time the Enterprises can remain in Conservatorship or prescribe any timeline or factors to initiate the exit therefrom. We believe it would be best for Congress, via a political consensus, first to resolve the threshold issues relating to the Enterprises' business model and the government's role post-Conservatorship in order to achieve the goal of returning the Enterprises to a "sound and solvent" condition as required under HERA. We therefore recommend that the FHFA suspend implementation of the ECF Re-Proposal until these fundamental threshold issues have been adequately addressed.

In preparing to respond to the ECF Re-Proposal, SFA conducted an outreach effort among our members so as to reflect accurately the viewpoint of our membership, which, given the diversity of institutions, we believe also accurately reflects the perspective of the U.S.

securitization industry at large.[1] We can confidently report to the FHFA that the views of our membership concerning the ECF Re-Proposal were remarkably consistent among all categories of membership, and that those views were most vigorously expressed by the book-runners (the people charged with arranging the financing for the Enterprises and other issuers of mortgage-backed securities), the investors (the people who purchase the risk-reward prospect of mortgage-backed securities) and the analytics firms (the people who assist the market in analyzing mortgage finance and credit).

II. Two Overarching Issues: Explicit Full Faith and Credit Guarantee on Agency MBS, and Treatment of Credit Risk Transfer

We offer at the outset two fundamental observations regarding the ECF Re-Proposal, which along with other observations will be further discussed in our letter.

A. Explicit Full Faith and Credit Guarantee on Agency MBS.

Our first observation is that any discussion of capital at the Enterprises must begin with a very basic question: post-Conservatorship, will the guarantees on the Enterprises' core pass-through mortgage-backed securities ("MBS") continue to be characterized as sovereign credits, or will they be characterized as corporate credits? We cannot overstate the importance of answering this question, as it could lead to a fundamental shift in who will and will not invest in these

[1] We note that the Enterprises themselves, however, did not participate in our process.

securities and therefore has implications for MBS pricing, the value of Enterprise debt and the pricing of mortgages for American homeowners.

With respect to sovereign credit, there are two possible variants: the "explicit" and the "implied". In either variant, we are assuming that any sovereign support would be provided in the form of a guarantee (or a backstop of the Enterprises' guarantees) that would attach to the MBS offerings only, rather than serving as general entity-level support. We are concerned that the FHFA is under the impression that some level of capital similar to bank capital will eliminate the need for an explicit guarantee and also eliminate the market perception of an implied guarantee that has existed for most of the Enterprises' histories. Such a belief is not accurate. Given the Enterprises' Charters, some degree of sovereign support will be assumed. As a result, a purported "privatization" of the Enterprises will burden the market with the role of quantifying the nature of this implied guarantee before pension plans, insurance capital and other long-duration financing can continue to play a role in financing this roughly $10 trillion market. Placing this onus on market participants is untenable and risks a repeat of the very mistakes that lead to and took place during the course of the financial crisis.

If the post-Conservatorship status of the Enterprises' MBS guarantees are characterized as corporate credits rather than sovereign credits – as the ECF Re-Proposal seems to contemplate – the Enterprises will then be in an entirely different business than has been the case since they were established in their modern pre-Conservatorship form in the late1960's and early 1970's. In fact, as we detail in this letter, it may be impossible in a post 2008-financial crisis world for them to remain in compliance with their current Charters under such an arrangement.

B. Capital Treatment of Credit Risk Transfer.

Our second observation regarding the ECF Re-Proposal, which also gets to the heart of the Enterprise funding model, concerns the credit risk transfer ("CRT") programs of the Enterprises that have developed during the Conservatorship and promoted, via the Scorecards, by the FHFA.

The ECF Re-Proposal is unfavorable to CRT transactions in general, and the capital markets programs (STACR and CAS) in particular. We believe that the Enterprises' use of CRT has itself significantly changed the pre-Conservatorship business model of the Enterprises for the better, and the practical implications of the ECF Re-Proposal's treatment of CRT threatens to undo much of the benefits of the CRT market which accrue both to the Enterprises as issuer, as well as to the investors in those securities.

As a result of the abundant historical data that has been made available by the Enterprises and the analytical and financial techniques of structured credit, the CRT program has allowed the Enterprises to price its risk-transfer offerings benchmarked to the "credit investor" side of the fixed-income market rather than the generally higher-priced corporate equity markets. Many analysts estimate that the CRT program results in a "cost of capital" to the Enterprises of about 6% compared to an equity "cost of capital" in the [9% - 10%][2] range, based on the cost of capital to other large financial institutions. This difference in the cost of capital results from the CRT program's ability to offer targeted, modeled tranches of risk, while common equity offers exposure to the undifferentiated risk inherent in "the business" as a whole. The CRT investors

[2] To be confirmed.

have assumed much of the credit risk that would otherwise fall to the equity holders in the same way that the MBS investors have relieved the equity holders of interest rate and liquidity risks. And, the CRT investors have done so non-dilutively, at a price lower than the equity cost of capital.

As further discussed in our letter, we believe the CRT program greatly benefits the Enterprises' equity holders as well as the taxpayers, facilitates any necessary capital raise needed in connection with exiting Conservatorship, and is fully consistent with the mandates of the Charters.

III. Specific Discussion Items

A. The Nature of the Guarantee.

The Congressional debate on "Enterprise Reform" during the Conservatorship has uniformly and on a bipartisan basis recommended that the agency securities issued by the Enterprises post-Conservatorship have the explicit full faith and credit support of the United State government. An explicit guarantee that is transparent, Congressionally-backed and paid for is one that the market could accept as sound policy. There is far less clarity around an implied guarantee going forward, which is what would result if the FHFA moves ahead with its plan to release the Enterprises from Conservatorship without a Congressionally-mandated backstop.

Without an explicit guarantee, it is likely the investor base for Enterprise MBS will shrink to some extent, while those remaining in the market would price in some uncertainty but largely be left attempting to gauge the likelihood of government intervention in the future. We believe the FHFA may be relying on the market to assume an implied guarantee to avoid the need to otherwise accept an enormous increase in yields required on Enterprise MBS. No reasonable amount of capital can overcome market uncertainty resulting from the lack of an explicit full faith and credit guarantee. The reason for this is simply one of scale: The support of several trillion U.S. dollars' worth of MBS requires a deep pool of investors with long-duration capital to commit. As the industry that buys, sells and trades the securities issued by the Enterprises, many of our members, particularly our investor members, have concerns that absent an explicit guarantee, the capital FHFA proposes is insufficient to attract and maintain MBS investors at the scale they do now. Instead, as we note, the market will be left to price the likelihood of a government rescue – e.g. the "implied guarantee."

Without explicit sovereign support for their MBS, it is likely that the Enterprises would no longer be eligible to participate in the TBA market, with broad implications for the continued availability of the 30-year fixed rate mortgage. This is especially true with the creation of the UMBS, whereby a buyer of a TBA can be delivered a security issued by either Fannie Mae or Freddie Mac. Already we see differences in the corporate risk between the two Enterprises. This would eliminate the UMBS as a viable security.

Another obstacle for the UMBS initiative is the proposed capital treatment of the cross-guarantees that the Enterprises will be required to issue in "Supers" offerings. The FHFA's 2018 "Proposed Rule on Enterprise Capital Requirements" (the "2018 Proposal", the predecessor proposal to the ECF Re-Proposal) would have required an Enterprise to assign Enterprise MBS a zero credit risk capital requirement. The ECF Re-Proposal, by contrast, assigns a 20% risk weight to exposure to the other Enterprise. The reasons given are that the 20% treatment is "[c]onsistent with the U.S. banking framework", along with what appears to be the expectation by FHFA that the Enterprises will not be explicit sovereign credits post-Conservatorship. (A zero risk-weighting would apply to the "full faith and credit" of the United States).

The increased fungibility and liquidity introduced through the development of the UMBS product in Conservatorship are at risk of being lost if more "friction" is introduced into the MBS and TBA markets via a capital charge imposed on one Enterprise for guaranteeing the credit of the other. An explicit guarantee would make this issue go away, but the capital treatment of UMBS in the ECF Re-proposal suggests that it will not go away. A 20% risk weighting would be a substantial headwind for the UMBS initiative, and another step backwards to the pre-Conservatorship regime.

The ECF Re-proposal seems to contemplate the post-Conservatorship status of the Enterprises' MBS guarantees to be characterized as corporate credits rather than sovereign credits. Some industry observers believe that the highest possible natural ratings achievable by corporate credits that are essentially in the mortgage insurance business would be "AA".[3] The Enterprises' product mix, volumes and pricing would all change dramatically as would the desire of investors (especially foreign investors) and even of the Federal Reserve (the "Fed", which currently owns approximately one trillion dollars of agency MBS) to purchase Enterprise MBS. Similarly, most other institutions that currently hold MBS will likely need to reduce the size of their holding by a substantial amount while many depository institutions may no longer be able

[3] See Whalen Global Advisors LLC, Comment Letter on Enterprise Regulatory Capital Framework June 2, 2020. "The published criteria of the major rating agencies contain structural obstacles to any federally insured bank or finance company achieving an unsecured rating above 'AA'."

to hold them at all and may suffer substantial losses (as was the case on depositories' holdings of Enterprise preferred stock at the time the Conservatorship was imposed). All of these effects would tend adversely to affect the ability of the Enterprises to carry out their current business, as that business is defined by their respective statutory Charters, including "provid[ing] stability in the secondary market for residential mortgages" . . . and "increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing".[4]

Another factor that the FHFA should consider in developing an ECF is preserving the current "Level 2A" treatment of Enterprise MBS for purposes of the "high quality liquid asset" ("HQLA") determination for the Liquidity Coverage Ratio with which banks must comply under Basel requirements, as implemented in the United States by the federal banking regulators. The FDIC defines Level 2A assets to include, among other things, "securities issued or guaranteed by a U.S. government sponsored enterprise that is investment grade" and that have been assigned a 20% risk weight. "Government sponsored enterprise" in turn is defined as "an entity established or chartered by the U.S. government to serve public purposes specified by the U.S. Congress but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. government".

The loss of Level 2A treatment would be a severe impediment to banks' appetite for Enterprise MBS, by directly reducing the amount of MBS banks would be permitted to hold. A related effect may be to make it more difficult for banks to meet the Liquidity Coverage

[4] See Federal National Mortgage Association Charter Act, 12 U.S.C. § 1716 *et seq.*, tit. III and Federal Home Loan Mortgage Corporation Act, Pub. L. No. 91-351, 84 Stat. 450.

Requirements due to the reduced supply of HQLA. The federal banking agencies have wide latitude in setting the requirements for HQLA, including requirements that define the types of entities that can issue HQLA. Should the FHFA proceed with the rule as proposed, it is imperative that the FHFA confer with the banking agencies to avoid these results.

In the event that any changes to the sovereign credit characterization results from administrative actions – such as amendments to the Preferred Stock Purchase Agreements (the "PSPAs") – rather than Congressional action, the questions would also arise as to how the Enterprises' new business complies with existing Charter mandates, as well as whether Congress will at some future point change the rules. While we assume that any potential discontinuance of the sovereign support would only be prospective, since the withdrawal of that support from the legacy MBS may be legally prohibited, some of our members have expressed uncertainty on this point.

We understand the chicken and egg dilemma facing the FHFA and, by extension, the Department of the Treasury and Congress. There is a desire to have the Enterprises exit the Conservatorship – twelve years is a long time – and we further understand that the exiting of Conservatorship would require an ECF to be in place. However, exiting from Conservatorship would also require that a business plan be presented to the market in connection with any necessary capital raise, and that means the development of a post-Conservatorship business model for the Enterprises is a condition precedent to both the exit itself, as well as to the adoption of an ECF. Put another way, the business model – particularly the role of sovereign support – seems to precede both the chicken as well as the egg.

We again emphasize that the ECF Re-Proposal will not and cannot replace the guarantee that currently exists while the Enterprises are in Conservatorship. For the ECF Re-Proposal to work, it would need to rely on the re-creation of an implied guarantee, which takes the entire industry back to the failed pre-2008 model of the Enterprises. We believe this reliance is very dangerous and may prove illusory in times of stress. A premature exit from Conservatorship would likely lead the market to assume a return of the implied guarantee – the model no one appears to support – which risks casting the entire decade in Conservatorship as an overall policy failure on every level.

B. The Credit Risk Transfer Program.

SFA agrees with the FHFA that common equity is, by its nature, the most versatile tranche of any capital structure, since it is available to absorb any risk and thus can plug any hole. CRT, as a structured credit product, is not that flexible as it, by design, covers specific risks of specific assets. But the risks CRT does cover is substantial and should not be discounted.

Prior to the development of CRT, the Enterprises (at least with respect to the MBS program and disregarding the investment portfolio) had successfully become distributors of two of the three primary risks inherent in their business: interest rate risk and liquidity risk. Both of these risks were voluntarily transferred to, and assumed by, the MBS investors when they purchased the pass-through MBS offerings of the Enterprises via arms' length transactions in one of the world's most liquid markets. Through the MBS program, the taxpayers were spared exposure to these two risks.

Prior to the CRT program, the Enterprises retained the third principal risk inherent in their business – mortgage credit risk. Since this risk remained with the Enterprises, the risk was assumed by the Enterprises' equity holders and by the taxpayers.

The bifurcation of interest rate and liquidity risk on the one hand, and credit risk on the other, has given rise to two distinct types of investment products in the mortgage space: (1) "rates" products, purchased by "rates investors" and (2) "credit products", purchased by "credit investors". These two products are consequence of the sovereign backstop of agency MBS. The agency retains the credit risk, the sovereign backstop provides the liquidity, and the liquidity allows the "rates investors" to assume and manage interest rate risk.

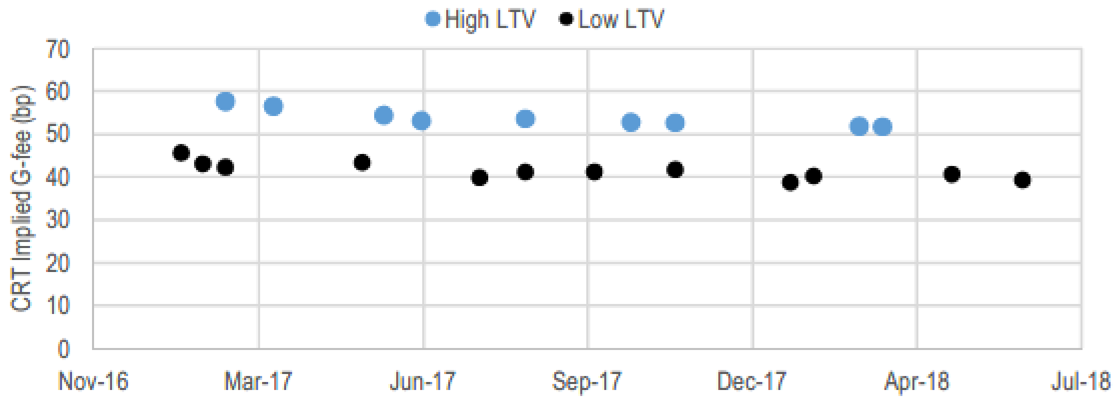
The Enterprises are monolines - companies involved in a single business. That business lends itself to the analytics and financial techniques of structured credit, where the available historical data can allow for more precise assessment of risks at various attachment and detachment points. This is the technique that allows securitization to price risk more precisely to appeal to targeted members of the "credit investor" community.

We do not believe that an accurate reading of the equity markets in general would suggest that equity investors seek the highest possible level of risk. Rather, they seek the highest risk-weighted reward. Whichever form the Enterprises take post-Conservatorship, it will not be as high-valuation companies. They will be monoline insurance companies, backed either by corporate credit with valuations in line with similar entities (or banks), or by sovereign credit with utility-style valuations. In either model we see the position of the common equity holders as being enhanced by an economically sensible use of CRT.

The FHFA makes a valid point in referencing “model risk” in the context of CRT. However, we see a substantial mitigant to this risk in the form of transparent market pricing. To enable the CRT market to develop, the Enterprises have developed and released a large amount of historical data, which sophisticated third-party analytics firms use to analyze the economics behind each CRT transaction. The pricing of the resulting transaction is then set by the informed decisions of the investors or other counterparty (as in the insurance-based CRT programs). As a general matter SFA believes that the market is best-positioned price risk, and the current CRT program provides sufficient price signaling back to the Enterprises and the FHFA to substantially mitigate the model risk.

As a policy matter, the CRT program also helps calculate a market-implied guarantee fee. Spreads on CRT securities can be thought of as the market's view of the guarantee fee (the “g-fee”). In fact, the FHFA itself, as part of its CRT progress reports, has calculated an implied g-fee using new issue CRT trading levels as shown in the chart below.

FHFA's calculation of the CRT implied g-fee



Note: FHFA stopped reporting these g-fees in 2018.
Source: JPM Research, "You break it, you own it: GSE capital framework and CRT", *https://markets.jpmorgan.com/research/email/-pa5128c/-V4_mSm4bGjC_elcpEGSWw/GPS-3447310-0.*

Moving forward, these implied g-fees can be an important guide for regulators and/or the Enterprises in calibrating the level of g-fees. Large differences between an implied g-fee and the actual g-fee could be a sign that g-fees need to be adjusted.

A number of our members, especially in the analytics field, have questioned in particular the 10% risk-weight floor, along with a 10% capital relief haircut, that the FHFA proposes to apply the "AH Tranche" of the capital markets CRT programs – the STACR and CAS transactions. The AH Tranche represents the "catastrophic" risk retained by the Enterprises after the risk-transfer represented by the CRT securities have been placed with private market investors.

One of the main reasons for the low capital relief provided by CRT is the 10% risk-weighted asset ("RWA") floor. This applies to the AH Tranche, which is the bulk of the deal and therefore, drives the economics of the transaction. In its recent webinar on the ECF Re-Proposal, the FHFA gave the following reasons for the 10% floor and the haircut:

- The proposed rule would assign a prudential risk weight floor of 10 percent to any retained CRT exposure.
- Under the 2018 Proposal, a retained CRT exposure with an attachment point greater than the sum of net credit risk capital requirement and expected loss would have had a risk weight of 0 percent, even though these exposures do pose some risk.
- The prudential floor avoids treating any exposure as posing no credit risk.
- The prudential floor is generally consistent with the U.S. banking framework, but less than the U.S. banking framework's 20 percent minimum risk weight for securitization exposures.
- FHFA sized the minimum risk weight for a CRT exposure to strike a balance between permitting CRT while also mitigating the safety and soundness, mission, and housing stability risk that might be posed by some CRT.
- Overall effectiveness – this adjustment increases retained exposure to 10 percent to reflect that CRT transactions may not provide the same flexibility, fungibility, and loss-absorbing capacity as equity capital, as discussed by several commenters on the 2018 Proposal.

Our analytic firm members do not find this reasoning persuasive, especially insofar as the reasoning appears to be based on the "overall effectiveness" of the CRT capital markets programs. The analytic firms consider the AH Tranche rather to represent remote, albeit catastrophic risk, and have argued that practical risk retained is much less, and the effectiveness of the CRT program is much greater.

As for our members who are not as well-versed in analytics, they are nevertheless puzzled by several things:

- Why is this retained risk treated so differently here than it is in the Dodd-Frank Act Stress Tests ("DFAST")?
- How is it that this retained risk was assigned a 0% risk weight in the 2018 Proposal, and, on the basis of an additional two apparently successful years of CRT transactions – which are now 100% cash collateralized – that risk weight has increased to 10%?
- If the retained risk is assessed in large part to be one of "general effectiveness", would not an approach similar to the 2018 Proposal's 1.5% leverage ratio charge against trust assets (the assets covered by the CRT program) be the correct approach?
- Does not the additional CRT 10% risk weight haircut double-count the required capital?
- How much of an effect would there be simply to adjusting the attachment points of the offered CRT classes?
- In short, how can the level of effective risk transfer be considered to have deteriorated so substantially in the past two years – and in apparent defiance of

the DFAST results? And why do the Scorecards continue to mandate extensive use of CRT?

In summation, the effects of the ECF Re-Proposal on CRT transaction raises significant questions about the future of the CRT programs at the Enterprises, and calls into question many of the policy rationales for why the CRT programs were developed, implemented, updated and supported since the inception of each program. While changes can and should be made to each Enterprise's respective CRT program, the imposition of a capital rule that significantly restrains or effectively ceases CRT issuance represents a radical departure from previous FHFA and Enterprise assumptions, away from Treasury recommendations, and away from market expectations.

C. Timing of the Re-Proposal; Coordination with Congress and the Department of the Treasury.

We appreciate FHFA's desire to make further progress towards drawing the Conservatorships to a close, and we recognize that a post-Conservatorship ECF is a necessary step in that process. However, many additional necessary steps remain outstanding, most of which impact the business model and role of the Enterprises in the housing finance system so drastically that we cannot see how a meaningful ECF can be promulgated at this time.

In its September 2019 "Housing Reform Plan", the Department of the Treasury ("Treasury") produced its plan for "administrative and legislative reforms" to the housing market (the "Treasury Report"). The Treasury Report contains a list of 49 "Legislative and Administrative Recommendations". None of the 49 items have a specific timetable or deadline attached to them, and many, if not all 49, are inter-related and need to be considered in the process of exiting the Conservatorship. Eighteen of the recommendations are addressed to Congress, which has acted on none of them, and given other national priorities resulting from the pandemic, is unlikely to act any time soon. Treasury makes clear at the outset of the Treasury Report that its "preference and recommendation is that Congress enact comprehensive housing reform legislation". Treasury also states that it "would support legislation that authorizes an explicit, paid-for guarantee backed by the full faith and credit of the Federal Government" and this is in fact the first of Treasury's 49 recommendations.

A fair reading of the Treasury Report suggests that Treasury believes that certain administrative actions that can be taken by Treasury and/or the FHFA should be taken, and that the entire process need not wait for Congress to act. While we agree that some discrete steps may be taken without Congressional action, we do not believe that the collective progress accomplished to date by Congress, FHFA and Treasury justifies the imposition of a fully-developed ECF to be implemented. Given all the unknowns, the ECF Re-Proposal presents a false sense of precision, and if implemented prematurely, could find itself on a seriously wrong track.

D. The Bank Capital Model is Inappropriate in Many Respects to the Enterprises.

It appears that the FHFA envisions a regulatory capital regime for the Enterprises that mirrors the capital framework applicable to commercial banks under the Basel framework. Although some aspects of the bank capital model make a good deal of sense – a risk-weighting approach and the use of periodic "stress tests" – others clearly do not – most notably, the leverage ratio.

HERA, especially its conservatorship and receivership provisions, is in large part modeled on the federal banking laws, in particular the Federal Deposit Insurance Act (the "FDIA"). The very fact of the Conservatorships perhaps draws the Enterprises optically even closer to a "bank model" approach, as conservatorship/receivership is not an uncommon remedy of the Federal Deposit Insurance Corporation (the "FDIC"). However, the similarities between the Enterprises and bank businesses break down, and ostensible similarities in "resolution authority" provisions of the applicable statutes do not provide a rationale for adopting an inappropriate framework.

Both commercial banks and the Enterprises assume three principal types of risk in their core lending business: interest rate risk, liquidity risk and credit risk. Bank balance sheets must bear the entire burden of these risks. Banks are "portfolio lenders" in a way that the Enterprises are not; indeed, the Enterprises are not even lenders.

Unlike banks, the Enterprises largely divest interest rate risk and liquidity risk through their pass-through MBS programs. The reason why MBS investors are willing to accept this risk is because the Enterprises (with the backing of U.S. taxpayers) have retained the credit risk and have provided the credit guarantee on the MBS. But with respect to two of the three types of risk, the Enterprises require very little capital compared to banks, simply because they have very little of those two types of risk on their balance sheets.

With respect to credit risk, however, the risk retained by the Enterprises is essentially the same as that retained by banks. In the case of credit risk, it does make sense to look to the bank model as a starting point. However, even this observation does not mean that a Basel risk-weighting should be mapped, provision-by-provision, onto the Enterprises, as there are differences that should be accounted for. For example, banks have much more diversified loan portfolios and may operate in a variety of different markets, offering different products in different currencies. Additionally, the Enterprises maintain an unusually large amount of historical data, and have a variety of levers over their counterparties, that would not be available to others. All of these factors may allow for a more precise level of risk-modeling that should not be ignored.

Another potentially useful element of a bank capital approach is the DFAST, which the FHFA has required the Enterprises to conduct since 2014 pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). The results of the most recent DFASTs were announced by the FHFA on August 15, 2019 for the period December 31, 2018 through March 31, 2020 (the "2019 DFAST Results"). The 2019 DFAST Results were modelled to a "severely adverse scenario" with high unemployment, real GDP declines, a 25% decline in home prices and other adverse financial conditions, including counterparty risk.

Although the DFASTs produce loss amounts rather than capital requirements, the basic results of one analysis can be meaningfully compared to the results of the other – the capital requirement would presumably be too low if it produced an amount of capital that did not cover the DFAST loss, plus a cushion.

The 2019 DFAST Results, as released by the FHFA, are set forth below:

Dodd-Frank Act Stress Tests – Severely Adverse Scenario Results

Cumulative Projected Financial Metrics (Q1 2019 - Q1 2021)

DFAST Severely Adverse Scenario Results – Combined

	Billions of dollars	Percentage of average assets[1]
Pre-provision net revenue[2]	$30.8	0.56%
(Provision) benefit for credit losses	(42.6)	-0.77%
Mark-to-market gains (losses)[3]	(2.5)	-0.05%
Global market shock impact on trading securities and counterparty	(6.4)	-0.12%
Net income before taxes	(20.7)	-0.37%
(Provision) benefit for taxes	(20.8)	.0.38%
Other comprehensive income (losses)[4]	(1.8)	-0.03%
Total comprehensive income (loss)	(43.3)	-0.78%
Credit losses[5]	($12.8)	
Credit losses (% of average portfolio balance)[6]	0.23%	

(1) Average total assets over the nine-quarter planning horizon.
(2) Includes net interest income, security impairments, operational risk losses, foreclosed property income (expense), and other non-interest income/expenses.
(3) Includes fair value gains (losses) on derivative and trading securities, and other gains (losses) on investment securities.
(4) Includes global market shock impact on available-for-sale securities.
(5) Credit losses are defined as charge-offs, net plus foreclosed property expenses.
(6) Average portfolio balance over the nine-quarter planning horizon.

The table shows a combined "total comprehensive loss" of $43.3 billion over the nine-quarter period calculated under the DFASTs' "severely adverse scenario". According to the "Fact Sheet" released by the FHFA in connection with the ECF Re-Proposal, the combined risk-based capital requirements for the Enterprises under the ECF would be $135 billion; when the buffers are added in, the combined capital requirement would be $234 billion.

Thus the capital requirements are multiples of the DFAST losses – over three times greater without the capital required by the buffers, and over five times greater with the buffers. The FHFA does not address or explain the disparate impact as between the DFAST approach and the ECF Re-Proposal.

In other contexts, the FHFA seems to agree with this point. For example, in the FAQs accompanying the 2019 DFAST Results, the FHFA made the following points:

- The Dodd-Frank Act requires financial regulators to use generally consistent and comparable stress scenarios [for the Enterprises and large bank holding companies]. FHFA provides the Enterprises with scenarios that generally align with the [Federal Reserve's] scenarios along with minor variations to address the Enterprises' business model.

- The generally adverse scenarios provide appropriate levels of stress testing that are specific to the Enterprises' unique lines of business. Further, in response to a FAQ as to why the Enterprises' credit losses are relatively low compared to credit losses observed at large bank holding comparatives, the FHFA responded that "the Enterprises experience a higher rate of success with borrowers by providing foreclosure alternatives which allow more borrowers to maintain home ownership. This results in more loan modifications and fewer charge-offs".

These FAQs from the FHFA support this argument: that even though any particular mortgage loan may have a specified level of risk that is the same whether that loan is on a bank balance sheet or in an Enterprise MBS, that does not necessarily mean that the regulatory capital needed to support that loans is the same. The Enterprises have the luxury of concentrating on a handful of mortgage products, and have had the opportunity to develop risk management techniques that are difficult for others to replicate, even with respect to those same products.

The FHFA and the Enterprises have had six years to fine-tune the DFASTs, and in the FAQs the FHFA acknowledges that variations from a bank approach are required to reflect better the Enterprises' specific businesses. We feel that much of the nuanced "lessons learned" from the DFAST experience has not been carried over to the ECF Re-Proposal.

E. Leverage Ratio Requirement.

Our next observation on the ECF Re-Proposal concerns the leverage ratio. Fundamentally, we question the need for this concept at all.

First, it is not clear to us what risk the leverage ratio is intended to address. Under the ECF Re-Proposal's leverage ratio approach, all assets are considered to be the same without distinction as to the quality (riskiness) of that asset. A different approach was taken in the 2018 Proposal, where one option presented was a "bifurcated" approach to the leverage ratio, with a 1.5% requirement applicable to "trust assets" – the pass-through MBS that transfers interest rate and liquidity risk to the investors – and 4% for other assets. By treating all assets as having the same level of risks, the ECF Re-Proposal's leverage ratio does not appear to be a credit risk management tool. And, since the MBS program already transfers away from the balance sheet the lion's share of interest rate and liquidity risks, it is not obvious to us that the leverage ratio is needed to address any residual risks in those areas, and if it is, perhaps a return to the bifurcated approach would be best.

We also believe that a leverage ratio, particularly when it is the binding requirement, will actually distort incentives by leading the Enterprises to discount credit risks and "risk up" the balance sheet with higher-yielding products. That cannot be a good idea.

Finally, the leverage ratio results in very harsh treatment of the CRT program since the assets subject to the CRT will typically remain on the balance sheet, regardless of the level of risk transfer to the private market investors. As per the FHFA's own analysis, the Enterprises' balance sheets will be constrained by the leverage ratio, which diminishes the impact of CRT, as shown in the chart below.

Combined enterprise capital as of September 2019

Risk-based capital requirements

	Total ($bn)	% of RWA	CET1 ($bn)	% of RWA	Tier 1 ($bn)	% of RWA	Adj Tot Capital	% of RWA
Base Capital	135	8%	76	5%	101	6%	135	8%
Buffers			99	5.9%	99	5.9%	99	5.9%
			175		200		234	
					Tier 1 ($bn)	% of Tot Assets		
Leverage Ratio Requirement					243	4%		

Note: Tier 1 leverage ratio requirements includes the 1.5% buffer. Leverage ratio requirement also calls for 2.5% core capital.

Source: JPM Research, "You break it, you own it: GSE capital framework and CRT", *https://markets.jpmorgan.com/research/email/-pa5128c/-V4_mSm4bGjC_elcpEGSWw/GPS-3447310-0*.

The effect is to present the CRT as uneconomic, since it results in no capital relief when the leverage ratio is binding. That makes no sense to us and cannot be a good idea.

The one purported advantage of the leverage ratio is its simplicity. However, that simplicity risks an outcome that is overly simplistic and does not account for the nuances and details of the Enterprises' business. A binding leverage ratio is simply too blunt an instrument to employ in this context, and its propensity to distort the balance sheet and discourage sound risk management, outweighs this one feature.

F. Countercyclicality.

Appropriately, the ECF Re-Proposal addresses the cyclicality of home prices. This cyclicality, referred to as the "housing cycle", typically last between five and 15 years. Like any cycle, it is unknowable when a cycle will end, and how low the trough will be – although historical experience has shown that when home prices fall sufficiently, the market is self-correcting as housing becomes seen as an attractive investment opportunity. Regulatory capital approaches to the housing cycle often look to whether current home price appreciation has deviated from the longer-term trend. The FHFA has adopted that approach.

Given the Enterprises' business, the end of a housing cycle is the event that produces the greatest risk to the business, since it is the event that crystalizes the credit risk in the Enterprises' portfolios. A drop in home prices is a major component of the DFAST, suggesting that there is a need to account for the housing cycle in the Enterprises' capital framework.

As noted above, the housing market has historically proven to be self-correcting on the downside, once homes become seen as an attractive investment opportunity. Thus, house prices do have a bottom, although nobody can know when that bottom has been reached. The DFASTs use a 25% home price decline in the “severely adverse scenario”.[5] The FHFA has sponsored a number of “Working Papers” on the housing cycle and the possible “lower bound” of the trough.[6] The analysis commissioned by the FHFA via the Working Papers series on the housing cycle and through the development of the DFASTs also allows for the estimations of the remoteness of risk.

The work put into the DFASTs and the research papers has provided useful analysis, but all of it also concedes the point that there is a remote risk of home prices falling through a conservative lower bound. It is the nature of this remote risk that underscores the necessary role of a full faith and credit guarantee as a fundamental precondition that must exist in addition to any ECF. Although remote risk can be priced, and the pricing of remote risk may be very low, the buy-side markets will demand that the counterparty promising to assume that remote risk be credible. There is only one counterparty that fits that role – the full faith and credit of the United States.

One way of addressing these risks – the fundamental risks borne by the Enterprises – is to have them internally hold sufficient capital to cover a prescribed level of remote risk. This poses a heavy burden on equity investors, who end up putting up capital that is underutilized during long periods – given that the expected housing cycle length is five to 15 years. A reasonable question equity investors might ask is whether risk management tools exist to lower the level of capital required per specified attachment points of risk.

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[5] *Dodd-Frank Act Test Results: Severely Adverse Scenario*, FHFA (Aug. 15, 2019).

[6] Alexander N. Bogin, et al., Working Paper 15-1, *How Low Can House Prices Go? Estimating a Conservative Lower Bound*, FHFA Working Papers (May 2015).

The CRT program provides such a risk management tool, albeit on specified reference pools of loans – and thus on specified pools of homes. As risks associated with home price declines become more remote, CRT investors are likely willing to assume those risks at very low price points. But finding CRT investors to assume risk at attractive prices is only part of the problem the Enterprises need to solve – they must also solve for counterparty risk on the part of the CRT providers. Assuming that the counterparty risk in CRT is fully or partially collateralized, as is STACR, CAS and some of the insurance programs, the collateralization requirement itself will at some point prevent further risk transfer, since, as noted above, only the United States is in a position to assume the remote catastrophic risk..

The FHFA expresses some concern in the ECF Re-Proposal that the availability of CRT transactions may become limited in times of stress – as when home prices hit a correction. The further suggestion is that this may be particularly true for the capital markets programs of STACR and CAS.

First, even if true, there may not be a problem. During the bullish phase of the housing cycle, one would expect that CRT bonds would have strong demand, providing coverage for the risks assumed during this phase of the cycle. Indeed, it would seem to make sense for the Enterprises to load up on CRT during the bullish phase, when loans may be the most risky and the cost of obtaining the credit protection is most attractive.

Second, we are not convinced that it is true. The COVID pandemic has provided a test case for the resiliency of the STARC and CAS programs. After a brief interruption, Freddie Mac resumed STACR issuance with two offerings in July 2020. Fannie Mae, on the other hand, has not resumed

CAS offerings – although this has not been due to the pandemic. Rather, as Fannie Mae announced on July 30, 2020, it was suspending the CAS program as a result of the ECF Re-Proposal's capital treatment for those transactions.

So, the recent history of the CRT capital markets programs reveals that the FHFA's worries that the market for CRT transactions may go away for an extended period of time may be unfounded – at least if one can remove the headwind of the capital treatment from the equation.

Neither is it true that the Enterprises' loan purchases were curtailed as a result of either the pandemic or the interruption of the CRT markets in April, May and June of 2020. Both Enterprises had very strong purchase volumes in that period. Thus, another worry of the FHFA's may also be unjustified – that the Enterprises' cannot fulfill their Charter mandates effectively if the CRT markets experience a temporary drop in investor demand. Indeed, everything has basically worked as planned, and the CRT program has demonstrated that it can provide a valuable tool to enable the Enterprises to "provide stability in the secondary market for residential mortgages" in accordance with the Charters, even through a once-in-a-century pandemic.

G. Additional Policy Consideration – Where Will the Volume Go?

We assume that the FHFA will receive numerous comment letters focused on the impact of the ECF Re-Proposal on mortgage rates. As a trade association concerned with secondary market issues, we ourselves will not give detailed consideration to primary market effects. However, we do believe that since we see the ECF Re-Proposal as increasing the Enterprises' cost of capital, and given that the cost of capital is the primary driver of the level of g-fees that are essentially the Enterprises' revenues, we see an increase in g-fees as a necessary consequence of the ECF Re-Proposal. An increase in the g-fees will lead to an increase in mortgage rates, which would likely divert the flow of certain loans away from the Enterprises.

As mortgage rates increase, bank portfolio lenders may be able to compete more effectively with the Enterprises due to an increase in the "net interest margin" on the loans – the widening of the difference between the mortgage rates and the banks' own cost of funds. Thus, fewer loans may end up in Enterprise MBS, and the foregone g-fees will instead become net interest margin income to banks.

Banks of course have also historically been recipients of U.S. Government support. And, apart from any "government bailouts" banks may have received during the 2008 financial crisis, the deposit insurance guarantee of the FDIC is also supported through Section 14 of the FDIA (12 USC Section 1824(c)). Beyond the support expressly provided by statute, as part of the Competitive Equality Banking Act of 1987, Congress expressed its intent in Section 901 that deposit insurance should be backed by the full faith and credit of the United States – essentially an implied guarantee beyond the limits of 12 USC Section 1824(a).

Were product to flow away from the Enterprises as a result of the ECF Re-Proposal, the second alternative would be the FHA, with loans being securitized into a full faith and credit Ginnie Mae MBS.

Lastly, the third alternative would be the private label securities ("PLS") market. The PLS market does not receive government support. From our point of view, a more robust PLS market would be highly desirable – our members have spent countless hours since 2008 on various initiatives attempting to revive that market. While we believe that those hours were well-spent, and that the PLS market can be a source of funding for mortgage credit in the United States, our efforts over the past decade suggests that work remains before PLS is positioned to take on a greater role in funding residential mortgages. SFA has been and continues to be engaged in the regulatory reform efforts outlined in the Treasury Report, as well as industry-led initiatives to revitalize the PLS market.

It would seem to us that "protecting the taxpayers" should be a goal of the Government on a comprehensive bases, and will not be necessarily advanced by a single agency – FHFA – driving mortgage risk towards two other entities – banks and FHA/Ginnie – that also depend on Government (taxpayer) support in whole or in part. In the case of FHA/Ginnie, the taxpayer risk is express, and has very little, if any, private capital in front of it. To the extent that protecting the taxpayers is a primary goal of the ECF Re-Proposal, we are not convinced that it meets that goal, and recommend that an analysis be conducted to determine more precisely where mortgage risk will flow, if not to the Enterprises, and the overall consequences to the taxpayers.

H. Additional Policy Consideration – Private Companies Leveraging Government Credit.

We remain very concerned about the moral hazard implications of returning the Enterprises to their pre-Conservatorship "privatized" status, with a reinstatement of the implied guarantee or Treasury guarantee on the Enterprises themselves. This dynamic has been shown to not work, and leads to risk taking and business decisions reliant on an assumed taxpayer safety net. Reform proposals have attempted to address this challenge in one of three primary ways:

converting the Enterprises into purely government entities; converting the Enterprises into utilities with capped rates of returns; or, placing an explicit guarantee on the Enterprises' MBS while converting the Enterprises into smaller companies with competitors who could go through a resolution process or bankruptcy without market disruption in the event one or more become insolvent. The existing ECF Re-Proposal ignores all of these options and instead returns to a pre-crisis model. We also believe this is unwise.

IV. Conclusion

The ECF Re-Proposal if adopted would create an overly complicated capital framework that we believe would be counterproductive to many of the FHFA's and Treasury's goals as presented not only in the ECF Re-Proposal itself, but also in the Scorecards and in the Treasury Report. Specifically, we do not see the prosed capital framework as benefitting the taxpayers, home buyers or the MBS investors. Nor do we see it as enhancing the prospects for a successful exit from Conservatorship or resulting in the Enterprises becoming attractive prospects for potential equity investors. Rather, we see much of the progress made during the Conservatorship being lost if the ECF Re-Proposal is adopted as proposed.

For all of the foregoing reasons, we recommend that FHFA suspend implementation of the ECF Re-Proposal until the fundamental threshold questions relating to the Enterprises' business model and the government's role post-Conservatorship have been adequately addressed. We also consider it important, during any period when the ECF Re-Proposal is still being considered or its implementation is suspended, for the FHFA to re-confirm its mandates to the Enterprises to continue to conduct the CRT programs as per the Scorecards previously issued. Otherwise, the Enterprises and the markets will continue to receive confusing and mixed messages regarding CRT.

The staff and membership of SFA remains committed to helping FHFA, Treasury and Members of Congress to think long, hard and creatively about these topics. We appreciate the opportunity to submit these comments on the ECF Re-Proposal. Please contact Michael Bright at (202) 524-6301 or michael.bright@structuredfinance.org to address any of the points raised in this letter.

Respectfully submitted,

Michael Bright
Chief Executive Officer
Structured Finance Association