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USMI Executive Summary of Comment Letter to the FHFA on Proposed Enterprise Capital Framework (ECF)

Overarching Observations and Concerns:

- **The Regulation Should Not Preempt Congressional Reforms.** Without congressional action, it is appropriate for the Federal Housing Finance Agency (FHFA) to take regulatory steps to ensure that the government sponsored enterprises (GSEs or Enterprises) will not present undue risks to the taxpayer when released from conservatorship. However, it is also important that FHFA regulatory actions do not effectively preempt potential congressional reforms. For example, Congress may determine that an explicit government backstop for catastrophic losses represents the best way to balance the public benefits provided by the GSEs and protection of taxpayers.

- **Capital Requirements Should Be Transparent and Analytically Justified.** The public and affected industry participants should be able to understand the basis for particular risk-weights, haircuts, and other elements of the proposal. Models used to determine these factors should be fully disclosed and empirically justified based on historical data. Transparency would provide credibility for the rule's requirements and an ability for the public to identify errors and to suggest improvements in the methods and models.

- **Insurance Capital Framework Should Be Used for Insurance Risks.** The proposed rule, even more so than the 2018 version, relies on a "mash up" of capital frameworks and incorporates many aspects of bank regulation, which is wholly inappropriate for the GSEs given that their core business activities and risk exposures are more akin to insurance. The bank business model is fundamentally different than the GSEs' business model and the risks assumed by banking organizations are not the same as the risks assumed by the GSEs.

- **Capital Requirements Must Be Balanced.** Capital requirements for the GSEs must be balanced, taking into account the impact of higher capital on housing finance and the risks to the taxpayer of the GSEs' activities. We are concerned that the proposed rule fails this standard by requiring capital levels that are significantly higher than necessary even under a severely stressed scenario. The proposed rule represents a significant increase (approximately $100 billion) in the overall capital required compared to the 2018 proposed rule and the FHFA increased the base credit risk grids without providing its rationale. The proposed 15% risk weight floor alone would increase required capital by 30% over the 2018 proposal.

- **<u>Capital Requirements Should Reduce, Not Merely Shift, Overall Risk to the Taxpayer</u>.** The proposed capital requirements will not reduce risk in the housing finance system but merely shift origination volume and credit risk to government-insured channels, namely the Federal Housing Administration (FHA). Many consumers, primarily lower wealth borrowers, could find themselves priced out of the conventional market and migrate to the 100% taxpayer-backed FHA. The reduced capital benefit of private mortgage insurance (MI), overly punitive treatment of the GSEs' credit risk transfer (CRT) transactions, and the proposed floors on mortgage exposures would all reduce the incentives for the GSEs to de-risk in the future.

- **<u>The Credit Risk-Based Capital Framework Should Be as Sensitive to Credit Risk as Possible</u>.** The proposed rule dilutes the credit risk-adjusted nature of the capital framework by combing risk-adjusted capital requirements with non-risk adjusted buffers and a *binding* non-risk adjusted leverage ratio. The layering of requirements – including various buffers, risk-weight floors, penalties for CRT transactions, multipliers, and haircuts – results in a credit risk standard that includes non-credit risk concerns and demands higher amounts of capital than is warranted by the GSEs' actual risk exposures. A credit risk-based framework should be as sensitive as possible to credit risk, yet the leverage ratio would be a binding capital requirement and supersede the risk-based elements of the framework.

- **<u>Proposed Rule Continues to Be Procyclical</u>.** The use of mark-to-market loan-to-value (MTMLTV) ratios and refreshed credit scores would result in a procyclical risk-based capital framework in which less capital would be required during good economic times (and thereby fuel the expansion) and more restrictive capital requirement in bad economic times (and thereby reduce credit availability and dampen economic recovery). The FHFA has proposed a countercyclical adjustment to address the use of MTMLTV but it is an overly complex element that is based on *national* house prices.

- **Proposed Rule Should Promote Private Capital Through the Use of Loan Level Credit Enhancement (CE) and Responsible CRT.** The 2020 proposed rule disincentivizes private capital from playing its important role in the housing finance system by diminishing the capital benefit the Enterprises receive from first loss loan level credit enhancement from private MI and from additional CRT. The reduced capital benefit of private MI, overly punitive treatment of the GSEs' CRT transactions, and the proposed floors on mortgage exposures would all reduce the incentives for the GSEs to de-risk in the future.

- **Improper Treatment of GSE Counterparties.** Counterparty haircuts are based on an opaque rating system what will result in subjective determinations that pick "winners and losers." The framework should rely on transparent and objective benchmarks for purposes of assessing counterparty strength and applying any counterparty haircuts.

- **Proposed Rule Fails to Provide Accurate Capital Benefit for MI.**
  - ***Capital Relief for Mortgage Insurance Should Be Objectively Determined, Consistent with Historical Data.*** Based on historical data, the CE Multipliers for guide level and charter level coverages should be 0.469 and 0.717 respectively, which is significantly lower than the CE Multipliers of 0.845 and 0.916, respectively, as proposed in the 2018 proposed rule, and also in the 2020 proposal. This needs to be corrected.
  - ***Capital Benefit Should Be Considered for Deeper MI.*** The 2020 proposal codifies only charter level and guide level coverage and does not contemplate MI coverage that could go beyond those two levels. There is no question that deeper insurance protection continues to reduce loss in the event of a default, and this increased benefit can be

statistically determined through an analysis of available data. This reduction in loss reduces risk and should be recognized in any *risk-based* capital framework.

- ***Determination of Creditworthiness and Concentration in Mortgage Risk is Subjective and Unjustified.*** This proposal applies counterparty haircuts based on a subjective determination, by the GSEs, of counterparty creditworthiness and concentration in mortgage credit risk. Secret and subjective determinations of this nature have the potential of causing great harm to the GSEs and to the housing markets. Further, the nature of these ratings is fundamentally unfair in that counterparties have no visibility as to how to improve their GSE-determined creditworthiness rating.
- ***15% Minimum Risk Weight Floor and MTMLTV Have Unintended Consequence of Diminishing the Risk Reducing Benefit the GSEs Should Receive from Private MI.*** The minimum 15% risk weight floor on single family mortgages will reduce the capital benefit of MI when the net capital required under the proposed rule would otherwise be below the 15% minimum floor. The same is true of the MTMLTV requirements, which under the proposed rule would kick-in after only six months after the loan is originated. The proposal also could diminish the MI benefit because of inaccurate assumptions made about MI coverage cancellation based on an amortization schedule that does not take into account other factors related to MI cancellation.

- **Credit Risk Transfer.** We support the use of CRT transactions as a tool to transfer a meaningful amount of credit risk in exchange for an appropriate amount of compensation. Properly priced and executed CRT transactions can meaningfully reduce the GSEs' risk, increase their capacity to provide liquidity, and protect taxpayers for mortgage credit risk losses. However, the proposed treatment of CRT represents a significant disincentive for the GSEs to use the transactions and would result in credit risk being more concentrated at the GSEs rather than distributed to other market participants. Two aspects of the proposed rule that are particularly concerning and negatively affect the economic feasibility of CRT are: (1) the 10% risk-weight floor on retained security positions; and (2) the requirement that the GSEs calculate its risk-weighted assets *as if* 10% of the risk sold off was still on balance sheet.

Recommendations for Modifications to the Proposed Rule:

- **<u>Capital Requirements Should Be Tailored to Reflect the Core Business of the GSEs</u>.**

1. The GSEs' primary function is that of a guarantee business, which is an insurance function, and therefore the Enterprises should be subject to insurance capital framework. If necessary, adjustments can be made to account for systemic risk.

2. The exclusion of future revenue on the Enterprises' existing books of business from the capital available to meet the credit risk capital requirements should be reconsidered. The NPR explicitly states that the capital framework is intended to ensure the Enterprises have *going-concern* levels of capital and, accordingly, the framework should recognize and give credit for the Enterprises' revenue.

- **<u>The Capital Rule Should Be Completely Transparent and Analytically Justified</u>.**

3. FHFA should make public all of the assumptions, models, and underlying calculations used to create the proposed framework in order to provide an opportunity for interested parties to understand the basis for the rule and submit comments.

4. There are layers upon layers of over-conservatism laced throughout the proposed rule. The current proposed capital levels are far above what was proposed in 2018, which also had elements of over-conservatism. The current proposal requires too much capital for the risks inherent in the GSEs' post crisis business and does not reflect the improved loan underwriting required by the GSEs. The capital charges should be adjusted to reflect the new underwriting required by the Dodd-Frank Act.

- **<u>The Risk-Adjusted Capital Rule Should Be Based on *Credit* Risk</u>.**

5. The risk-adjusted capital rule should be as risk sensitive as possible. Elements in the risk-adjusted rule that reduce risk sensitivity should be removed or made more risk sensitive. The capital added for non-credit risks, such as interest rate risk, global warming risks, and hypothetical political risk should be deleted. These non-credit risk concerns should be dealt with through separate regulatory requirements, such as the recently adopted liquidity standard, or through an operational risk requirement or supervisory oversight.

6. The leverage ratio is a back-stop for unusual circumstances. It should not be set so high as to be the binding capital requirement at the initiation of a new risk-adjusted framework. It should also be based on GAAP assets and calculated in a manner that reflects the mortgage risk actually held by the Enterprises and recognizes the credit risk that is transferred to other market participants, such as MI and CRT.

7. The use of MTMLTV ratios does not appropriately capture regional bubbles and can have a dramatic impact on capital required. FHFA should modify the rule so that the countercyclical adjustments for single-family mortgage exposures are based on original LTV for the first 3-5 years, after which national or, preferably, regional MTMLTV house price deviations could be used.

8. The buffers should be based on risk-adjusted assets. The minimum 15% floor for single-family mortgages should be removed. The minimum 10% floor on CRT will make CRT uneconomical and should be removed.

- **<u>FHFA Should Reevaluate the Treatment of Counterparties to Create a Transparent and Objective Assessment Framework</u>**

Private MI

9. The proposed regulation includes a completely subjective determination of counterparty creditworthiness and mortgage risk concentration. Counterparties that meet the requirements of the GSEs' Private Mortgage Insurer Eligibility Requirements (PMIERs) should not

be subject to subjective determinations of creditworthiness and should not be subject to a haircut. The single-family risk multipliers and credit enhancement multipliers should be revised in certain respects.

10. The CE Multipliers on seasoned loans with cancellable MI need to be re-calibrated to distinguish loans in which the MI has *actually* been cancelled and loans that are still covered by MI, notwithstanding the 80% cancellation and 78% termination triggers.

11. In addition to the procyclical and overly conservative effects that the proposed 15% risk weight floor and MTMLTV requirements have on overall capital, they have significant, and presumably unintended, consequences on the benefit that the Enterprises attain from this source of important underwriting and capital standing in a first-loss position. As previously stated, the 15% risk weight floor should be removed. The MTMLTV requirement should be adjusted to use original LTV for 3-5 years, after which MTMLTV could be used.

CRT

12. The proposed 10% floor on CRT will make the transactions uneconomical and should be removed. To ensure that CRT deals meet supervisory expectations without the implementation of punitive capital treatment, the FHFA or GSEs should establish and make public: (1) a transparent model to assess the capital benefit for CRT; and (2) a specific set of disclosures and requirements for CRT structures.