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**August 31, 2020**

The Honorable Mark Calabria
Director
Federal Housing Finance Agency
Constitution Center
400 7th Street, SW
Washington, D.C. 20219

Dear Director Calabria:

On behalf of the 1.4 million members of the National Association of REALTORS® (NAR), I submit this letter in response to the notice of proposed rulemaking (proposed rule), *Enterprise Regulatory Capital Framework (RIN-2590-AA95)*. NAR appreciates the efforts the FHFA has brought to this critical issue. In several areas this proposal makes strides in reducing cyclical risk and supporting underserved borrowers. However, in other areas the proposal would harm taxpayers, reduce competition, and hinder the Enterprises' ability to carry out their critical congressionally-chartered mission to support a national mortgage market.

The National Association of REALTORS® is America's largest trade association, including NAR's five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,200 local associations or boards, and 54 state and territory associations of REALTORS®. NAR represents a wide variety of housing industry professionals, including approximately 25,000 licensed and certified appraisers, committed to the development and preservation of the nation's housing stock, along with its availability to the widest range of potential homebuyers.

Homeownership is a central part of the fabric of the American dream and the Enterprises play an important role in helping achieve that dream. The Enterprises' congressionally-mandated mission of providing liquidity to real estate investment in all markets and at all times is a central fixture of the U.S. mortgage finance system. A critical weakness of the Enterprises before conservatorship was their undercapitalization, which must be rectified. However, care must be taken in redesigning the GSEs' capital framework to appropriately protect taxpayers, stabilize markets, and support homeownership.

**A Bank-Centric Update to the 2018 Proposal**

The 2020 proposed rule takes as its foundation the rule proposed in 2018, but makes a number of meaningful changes. The 2018 rule introduced

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several measures of risk used in banking regulation, while the 2020 rule adds measures of risk or parameters that are specific to banks and not insurance companies like the Enterprises. At its core, the proposal would require the enterprises to hold a capital level that is the greater of a risk-based rule – where the level is roughly the 2018 proposal plus several, significant buffers and additional bank-like rules on the types of capital used, or a leverage ratio equal to 4.0%. Laudably, the FHFA would limit the GSEs' ability to distribute dividends if their prescribed stress, stability, and countercyclical buffers fell below minimum thresholds.

The current proposal also makes strides in limiting the countercyclicality of the proposal from 2018 through the use of collars on price growth. This effectively limits the impact of mark-to-market practices that would reduce the capital the GSEs hold just as risk increases. Furthermore, the rule reduces the burden on single borrowers and those using small-dollar loans.

However, at a more nuanced level, four changes are problematic and would drive an adverse impact to the market and finance system:

i. A minimum 4% leverage capital level and risk-based buffers are imposed that are invariant to risk.
ii. The regulatory capital value of CRT is eliminated.
iii. Revenue is excessively discounted.
iv. Capital is determined in the context of a run-off portfolio instead of an ongoing enterprise.

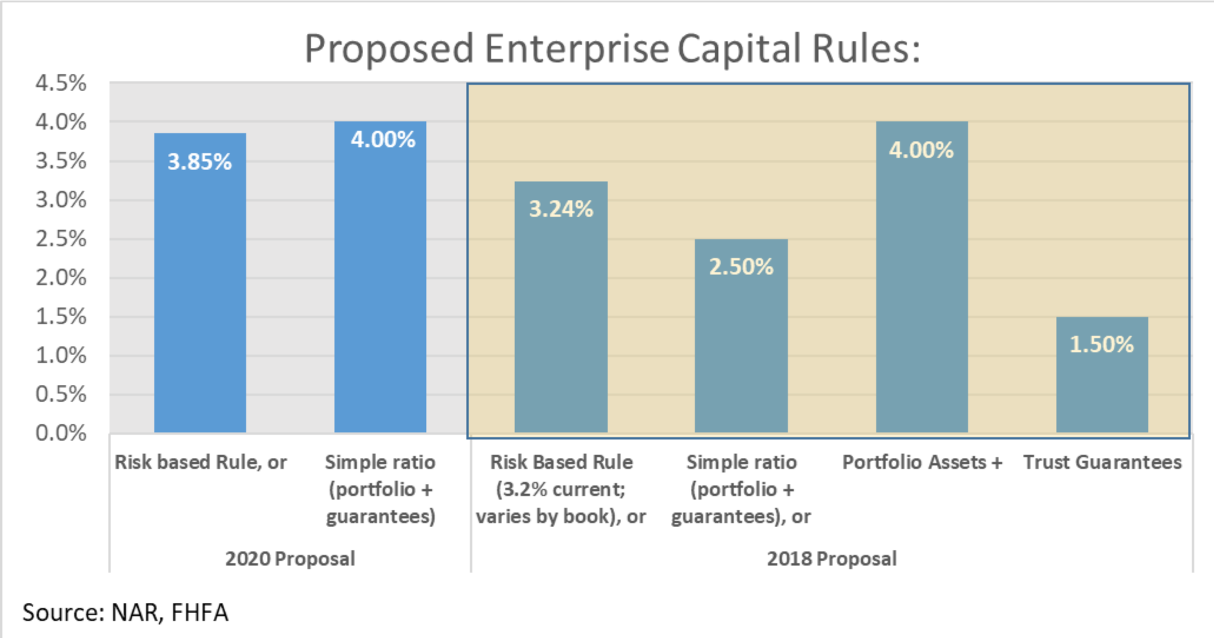
The proposed rule has the effect of raising the level of capital well beyond an economic level plus a buffer and simultaneously forcing the GSEs to use a higher cost of capital. Each of these issues is addressed in further detail below.

**Capital Should Reflect Risk**

Under the severely adverse scenario of the 2019 Dodd-Frank Act Stress Test (DFAST), the FHFA determined that the stress losses of Fannie Mae and Freddie Mac would amount to 0.83% of assets if home prices fell by 25% over nine quarters and GDP fell 8.0%. While this scenario is moderately more optimistic than the 30% decline experienced in the subprime crisis, it is very close. Nonetheless, it is prudent to impose a buffer on top of this stress losses to compensate for unforeseen market liquidity, modeling error, and to allow the Enterprises to operate through a crisis. In the 2018 proposal, the FHFA proposed a 75-basis point going-concern buffer on top of the risk-based approach. The 2020 proposal would rename the going-concern buffer to a stress capital buffer and add two additional buffers. The stress capital buffer and new stability capital buffer would add $53.3 billion to the GSEs' capital requirement, while the new countercyclical capital buffer is initially set at zero, but would rise when "excess aggregate credit growth is judged to be associated with a build-up of system-wide risk".[1]

The value of these buffers is unclear. The countercyclical buffer is still theoretical and must be modeled and vetted by experts, while the stability buffer undermines the congressionally chartered mission of the Enterprises to support liquidity in all markets including underserved communities and during periods of stress. Specifically, the stability buffer, which grows in proportion to the Enterprises' role in the market, would rise in a crisis, precisely when the GSEs should be taking a more supportive role that implies a larger market share.. NAR agrees that entities the size of the Enterprises pose a unique risk to the market, but excess capital is no substitute for effective oversight, transparency, and regulation. Thus, the invariant portion of the risk-based approach would amount to 1.6% in 2019, even with no countercyclical buffer in place, accounting for nearly half of the 3.85% estimated capital required on the 2019 book of business.

[1] Federal Housing Finance Agency, *Fact Sheet: Re-proposed Rule on Enterprise Capital*, (June 2020).




Like the 2020 proposal, the 2018 proposal stipulated that the binding capital level would be the greater of a risk-based approach or a leverage ratio. In the 2018 proposal, the leverage ratios were either a risk invariant 2.5% or a bifurcated 4% for portfolio assets and 1.5% for trust guarantees. The 2020 proposal raises the minimum to 2.5% for core capital and 1.5% of adjusted total assets for a total of 4%. This approach is problematic as it does not incentivize the Enterprises to externalize their credit risk or encourage them to innovate ways to safely assume that risk.,

The secondary market is supported by entities with varying business models that reflect their unique risk structures. Banks and real estate investment trusts portfolio mortgages and may securitize them, so they are exposed to both credit and rate risk. The Enterprises on the other hand, have reduced their portfolios under conservatorship and externalized credit risk through various channels. Thus, their exposure to both credit and rate risk has fallen dramatically, greatly benefiting taxpayers. Raising the leverage ratio to a single, high ratio incents the Enterprises to do the opposite. The potential to miss the risk-based requirement will cause the Enterprises to hold more capital as a buffer against this risk.[2]

Furthermore, the proposed leverage ratio implies that capital held against the lowest risk borrowers must be no less than 4.0%, yet this amount analytically corresponds to some of the highest risk borrowers. The impact is that the Enterprises will likely need to raise fees for these low-risk borrowers, driving them to portfolios or private label securities (PLS). The low-risk borrowers, however, provide the excess revenue used to offset the higher capital charges of mission eligible borrowers like those with low and moderate income or to fund the Enterprises' disaster response and duty to serve programs. Worse, to achieve returns that meet the required 4% leverage ratio, the Enterprises will need to increase the risk of their portfolio to compensate investors for the higher required capital. In short, the higher leverage ratio incents the Enterprises to internalize risk and to take on more of it.

Federal Reserve economists have demonstrated that the increase in required leverage ratios on banks of all sizes since the Great Recession has resulted in additional risk taking. [3] The risk invariant nature of this proposal, as encapsulated in the higher leverage ratio and buffers, would expose taxpayers to greater risk, undermine the robust pricing and insights from global markets for MBS and CRT (discussed in more detail below), and reduce the supply of investment assets for banks and other investors, endangering the entire system rather than making it safer.

[2] Reinsurance Association of America, FHFA 2020 Proposed Capital Rule Impact on Credit Risk Transfer, (August, 2020).
[3] Donald P. Morgan, Dong Beom Choi, and Michael R. Holcomb, *Leverage Ratio Arbitrage All Over Again*, *Federal Reserve Bank of New York Liberty Street Economics*, (June 30, 2020) https://libertystreeteconomics.newyorkfed.org/2020/06/leverage-ratio-arbitrage-all-over-again.html.

**Cost of Capital is Inefficiently Inflated**

Another touted goal of the 2020 proposal is to "increase the durability of capital." The rule specifies percentages of capital that must be represented by tier one and CET1 capital, indicating a higher degree of resiliency and liquidity in a crisis. Similarly, the 2020 proposal raises the risk-weight floor from zero to 15%. However, the latter change raises the minimum capital required against the lowest risk borrowers and raises the cost for those borrowers. The FHFA justifies the change based on the extraordinary support from the Federal Reserve and federal government during the Great Recession and risks that are unaccounted for such as flood, fire, and earthquakes.

REALTORS® are sympathetic to the desire to make all risks transparent and accounted for, but note that the government's extraordinary actions in the subprime crisis were due in part to the lack of sufficient standards and oversight across loan products and underwriting, which have been largely remedied by improvements in the ability to repay standard, data sharing, valuation and risk modeling, portfolio limitations, and the existing conservation capital framework. Furthermore, the government's actions cited by the FHFA in the last crisis reflected a flight of private demand in both the public and private markets that only a sovereign entity has the long-term capacity to offset as evidenced by the pandemic response. Finally, raising the risk-weight floor to account for catastrophic risks disincentivizes the GSEs from finding a more efficient means of laying off this risk to the private markets.

The leverage ratio and minimum risk weights have particularly onerous effects on one of the core successes of GSE reform to date – the Enterprises' tremendous expanse of credit risk transfers (CRT). Specifically, the minimum 4.0% leverage ratio discussed above would apply to CRT deals, raising the cost of capital and making them inefficient. Likewise, the higher risk weight on all assets and a 10% risk weight on retained CRT in the risk-based approach would force the GSEs to either externalize the portion of credit risk that they are more efficient at holding or internalize all credit risk.

The 2020 proposal would also result in CRT transactions receiving less credit for loss relief. Don Layton, former CEO of Freddie Mac and Resident Industry Fellow at the Harvard Joint Center for Housing Studies, noted that the change to CRT treatment "shrinks by almost 50 percent the capital benefit of CRT transactions versus the 2018 proposal, probably rendering any such transaction uneconomic."[4] Thus the GSEs would be forced to use more expensive CRT financing to reduce internal risk or not use CRT execution and increase retained risk. Either outcome means higher costs for consumers and/or increased risk for taxpayers, as the GSEs opt to hold credit risk rather than laying it off in debt markets to remote third parties who pay in cash for the risk upfront. The CRT market is one of the great successes of GSE reform to date. Through the second quarter of 2019, the CRT market has allowed the Enterprises to shed a portion of the risk on more than $3 trillion, while allowing hundreds of market participants to bid on CRT deals, providing transparency and competitive, market-based pricing of this credit risk.[5] The proposed treatment of CRT would eliminate these benefits.

**Revenue Matters**

Under the 2018 rule and the 2020 proposed rule, no credit is given for guarantee fee (g-fee) revenue that the Enterprises continue to earn during a crisis. However, guarantee fees provide an important and reliable source of loss absorbing capacity that should not be ignored. During the subprime crisis, roughly 92% of GSE borrowers remained current on their mortgages, while servicers advanced the fees on the remaining 8%. This rule runs counter to the Dodd-Frank stress tests for banks, treating the GSEs differently from banks despite the stated goal of leveling the playing field for all players. While it can be argued that income is certainly unstable through the cycle, reducing its value rather than eliminating consideration it is a more mindful approach.

**The Enterprises Have a Long-term Focus, the Proposed Capital Rule Should as Well**

Unlike other private entities in housing finance, Fannie Mae and Freddie Mac were chartered by Congress with a public mission, part of which is to support the national housing system in all markets, including during a crisis. This commitment by the government to support the market through these entities implies that the Enterprises are intended to endure even if their equity investors do not. Thus, the capital rule should reflect their full

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[4] Layton, Don. "The New Proposed Capital Rule for Freddie Mac & Fannie Mae: Ten Quick Reactions". Harvard Joint Center for Housing Studies. May, 2020.

[5] Federal Housing Finance Agency. "Credit Risk Transfer Progress Report: Second Quarter 2019". November, 2019

operating potential *through a stress event* as they are designed to be long-lasting. The Enterprises will continue to do business even after the worst year in a stress event, earning income and being able to access debt markets after peak losses. The capital rule should be modeled to reflect this special nature of the Enterprises' construct and the relationship with the federal government either through an explicit, paid-for guarantee agreed to by Congress or as a paid for, limited guarantee through the Treasury's backstop. Modeling for a single year's losses and ignoring earnings from the GSE's entire book of business is neither economically efficient or reflective of the Enterprises' special charter mission and would unnecessarily raise costs for consumers.

**Other Issues the Capital Rule Must Address**

A number of other factors will either directly or indirectly interact with the capital rule and affect the Enterprises' safety and soundness, their ability to satisfy their charter duties, and the return that potential investors would face. The FHFA must clarify these factors for the market, investors, and consumers before finalizing the proposal. The Enterprises revealed in their second quarter, 2020 10-Q filings that the FHFA mandated new liquidity rules, e affective on September 1st of 2020. These rules affect the type of assets the Enterprises must hold to satisfy liquidity requirements over both a 30-day period and a 365-day horizon. In addition, the GSEs must satisfy a minimum ratio of long-term debt to less-liquid assets as well as minimum asset funding parameters. In response to this change, both Enterprises indicated their net interest income would be reduced. One analyst also linked Basel requirements for higher quality liquid assets and high leverage ratios to risk taking and a decline in market making.[6] Thus, the new liquidity requirements could raise consumers' costs and exacerbate risk taking driven by the proposal's high leverage ratio, undermining safety and soundness and the Enterprises' ability to support liquidity in mortgage investments in all markets under all conditions. The FHFA must reconcile these new liquidity requirements with the proposed rule, so potential equity investors can evaluate their impact on implied returns and to allow the policy community to better understand the overall impact on consumers, the Enterprises' charter duties, and safety and soundness.

The ability of the Enterprises to access low cost debt in a crisis is a direct function of their currently explicit line of credit with the Treasury and the implicit line of credit before conservatorship. Low cost debt allows the Enterprises to make low-cost mortgages in a crisis, but Federal backing of the Enterprises' MBS allows the Federal Reserve to purchase these low-cost mortgages in a crisis, just as it did when it stepped into the market in the early days of the pandemic. When the Federal Reserve bought the Enterprises' MBS earlier this year, it stabilized mortgage rates and upheld the housing market, while the private market virtually shut down. What's more, Wall Street analysts point to the general government support as evidence of franchise value and have downgraded the Enterprises on news that government support could be diluted.[7] For these reasons, REALTORS® support an explicit, paid-for backstop from the federal government. Potential equity investors need clarity on this support, as do the housing, lending, and construction industries, which account for nearly 20 percent of the economy and which are critical to pandemic recovery efforts.

The Office of Management and Budget (OMB) has recognized that the GSEs have a "public mission to provide stability in and increase the liquidity of the residential mortgage market and to help increase the availability of mortgage credit to low- and moderate-income families and in underserved areas."[8] In this proposal, the FHFA has created a risk-based rule with multiple buffers and a leverage rule in an attempt to provide adequate capital to cover risks to the GSEs' book of business as well as to allow them to continue to operate during a stress event. REALTORS® appreciate this effort, but are concerned that in specifying capital for individual borrower profiles, those individual capital profiles will in turn be used to specify guarantee pricing for individual borrowers. Without an accompanying framework to outline how the GSEs should allocate rates of return to support the public mission, these risk-based capital standards could result in risk-based pricing that will increase the cost significantly for those borrowers that the GSEs are explicitly tasked with supporting.

Mortgage rates and access to credit have a direct influence on home purchases, homeowners' ability to use equity in their home, and the overall economy. The Consumer Financial Protection Bureau is required by law section 1022(b)(2)(A) of the *Dodd-Frank Act*, "to consider the potential benefits and costs of a regulation to consumers and covered persons" and shared that analysis with the public in its recent proposal to replace the qualified mortgage standard.[9] While the law does not apply to the FHFA, given the sheer magnitude of the

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[6] Hannah Lang. "Fannie, Freddie to face bank like liquidity standards starting Sept. 1". American Banker. July 31, 2020

[7] Moody's Investor Services. "Recommended housing reforms would be credit negative for GSEs, open opportunities for other lenders". September 6, 2019.

[8] https://www.whitehouse.gov/wp-content/uploads/2018/02/gov-fy2019.pdf

[9] Consumer Financial Protection Agency. "Qualified Mortgage Definition under the Truth in Lending Act (Regulation Z): General

number of consumers that could be affected by this rule and the potential impact to the housing market and economy, the FHFA should provide an analysis on all affected parties, including homebuyers, homeowners, and investors, in addition to the economy.

Finally, while capital is critical to aligning risks and protecting taxpayers, excess capital is no substitute for an effective structure and oversight. To this end, REALTORS® have proposed transitioning the Enterprises to Systemically Important Financial Market Utilities (SIFMU).[10] As SIFMUs, they would maximize private capital to support a public mission and produce competitive outcomes. Guarantee fees would be informed by insights from private markets for CRT and MBS as well as equity analysts. Furthermore, their regulator would be empowered to enforce transparency on the entities, both protecting taxpayers and making sure more borrowers benefit from the SIFMUs? charter required duties. Finally, the enhanced transparency would also allow market participants, such as investors, mortgage originators, and servicers who generate the mortgage product, could respond competitively to risky or adverse behavior by the SIFMUs.

**Conclusion**

Thank you for your time and contributions to this important topic. While the proposal provides some important innovations, REALTORS® are concerned that the proposed rule will undermine both the Enterprises' support for homeownership and the economy, but also harm taxpayers and the safety and soundness of the housing finance ecosystem. NAR looks forward to working with the FHFA to reshape the Enterprises to continue its robust housing mission. If you have any questions, please contact Ken Fears, NAR's Senior Policy Representative for Conventional Finance and Lending Policy, at 202.383.1066 or KFears@NAR.REALTOR.

Sincerely

Vince Malta
2020 President, National Association of REALTORS®

QM Loan Definition" RIN 3170-AA98. June 22, 2020

[10] Cooperstein, Richard, Fears, Ken, and Wachter, Susan. "A Vision for Enduring Housing Finance Reform". The National Association of REALTORS®. February, 2019.