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**National Community Stabilization Trust**  
**National Fair Housing Alliance**  
**National Housing Conference**  
**National Urban League**  
**UnidosUS**

**Comment to the Federal Housing Finance Agency on Enterprise Regulatory Capital Framework**

**12 CFR Parts 1206, 1225, 1240, and 1750, Document No. 2020-11279, RIN-2590-AA95**

**August 31, 2020**

**Submitted electronically via regulations.gov and via email to RegComments@fhfa.gov**

## **I. Introduction and Executive Summary**

Thank you for the opportunity to comment on the Federal Housing Finance Agency's (FHFA's) re-proposed rule on capital requirements for Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs).

In our view, the proposed rule erroneously treats the GSEs as banks and therefore requires bank-like capital. This leads to gratuitously high capital levels that run directly contrary to the GSEs' charter mission to promote access to mortgage credit to underserved borrowers, to serve a countercyclical role in the mortgage market, and to FHFA's duty to reasonably support the safety and soundness of the GSEs and U.S. housing finance system.

The proposed rule's approach would unnecessarily increase costs and reduce mortgage credit availability, with an acute impact on low- to moderate-income families and families of color. It would do this directly, by pricing out of the GSE channel many borrowers with lower credit scores and higher loan-to-value (LTV) ratios, and indirectly, by pricing out higher credit score and lower LTV borrowers that generate much of the current system's cross subsidy to make its loans more affordable.

The rule would hamstring the GSEs in fulfilling their countercyclical mission in a crisis. It would shrink the conventional market's footprint, likely shifting significant volume to FHA, and leave more of the mortgage market subject to the swings of portfolio and PLS markets, which tend to dry up quickly in times of stress, including the financial crisis of 2008.

And the rule would not reduce risk to the overall housing finance system, but rather simply redistribute and concentrate it. By removing the GSEs' incentive to distribute their credit risk, the rule would lead to more risk being held at the GSEs despite their smaller market share.

Moreover, consistent with the GSEs' mission, FHFA should consider the impact on low- to moderate-income borrowers and borrowers of color. We support FHFA's attempt to provide a more level application of capital requirements across risk levels to reduce the relative penalty that lower-wealth families pay for large-scale and systemic events over which they have no control and from which they disproportionately suffer. However, the combination of excessive overall capital requirements and a minimum that is too high for low-risk loans in the proposed rule would result in net increases in costs for lower-wealth families. As described in section IV, the proposal would have a disproportionate impact on people of color, intensifying pricing disparities and making mortgage credit more expensive and less available, thereby aggravating the racial wealth gap.

The proposed rule is thus critically flawed as written. We recommend that FHFA:

- 1) Refrain from adopting bank capital rules for the GSEs;
- 2) Count a portion of guarantee fee revenue as capital for risk-based capital requirements;

- 3) Treat properly discounted CRT as a component of required credit risk capital;
- 4) Eliminate the punitive stability capital buffer and the countercyclical capital buffer;
- 5) Lower the leverage ratio to the alternative proposal from the 2018 proposed rule of 1.5% for trust assets and 4% for retained portfolio; and
- 6) Regulate the GSEs as utilities to promote affordability and more equitably serve low- to moderate borrowers and families of color, as well as to promote safety and soundness of the GSEs.

## **II. The GSEs' Public Interest Duties Should Shape the Final Rule**

In exchange for government support, the GSEs have an explicit public interest mission. This mission is foundational and part of their charters – the GSEs' very reason for existing.<sup>1</sup>

There are three essential components to their mission. First, the GSEs were created to promote access to credit throughout the Nation, with an emphasis on housing for low- and moderate-income families and underserved areas. To this end, the GSEs must also ensure that fair lending is at the root of all their activities. According to their charters, the GSEs are required to report to Congress on how they “assess underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures, that affect the purchase of mortgages for low- and moderate-income families, or that may yield disparate results based on the race of the borrower, including revisions thereto to promote affordable housing or fair lending.”<sup>2</sup>

As part of their mission, the GSEs are to pursue “activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return *that may be less than the return earned on other activities . . .*” (emphasis added).<sup>3</sup> The GSEs do so pursuing lower required but positive returns for certain purchase and rate-term refinance borrowers, particularly those who are lower-income or lower-wealth. Indeed, as quasi-insurance companies, a crucial function of the GSEs is to pool risk nationally. Pooling risk is key to the GSEs’ ability to serve underserved borrowers and meet their charter mission.

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<sup>1</sup> See 12 U.S.C. § 1716; 12 U.S.C. § 1451. The legislated purpose of the GSEs, as stated in their charters, is to:

1. provide stability in the secondary market for residential mortgages;
2. respond appropriately to the private capital market;
3. provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;
4. promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;
5. manage and liquidate federally owned mortgage portfolios in an orderly manner, with a minimum of adverse effect upon the residential mortgage market and minimum loss to the Federal Government.

<sup>2</sup> See 12 U.S.C. § 1456(f)(2)(G).

<sup>3</sup> 12 U.S.C. §§ 1716(4) and (3).

Second, the GSEs have a countercyclical mandate to provide liquidity through all market cycles. This is reflected in their requirements to “provide stability in the secondary market for residential mortgages”, “respond appropriately to the private capital market”, meaning fill in for it when it retreats, and “provide *ongoing* assistance to the secondary market for residential mortgages” (emphasis added). Unlike other participants in the housing finance system, the GSEs are needed to continue providing mortgage liquidity in a crisis or the entire housing finance system will seize up, harming the national economy. For example, during and after the 2008 financial crisis, private-label securities (PLS) funding evaporated; the GSEs, along with Ginnie Mae, picked up the slack.<sup>4</sup> Moreover, the GSEs are playing a critical role during the COVID-19 crisis. As the Urban Institute found, during the first six months of 2020, the GSEs added \$214 billion in net issuance, while the non-agency market dramatically pulled back because of COVID-19 liquidity concerns.<sup>5</sup>

Lastly, as the GSEs’ regulator, FHFA must promote the safety and soundness of the GSEs *and* the housing finance system. Under the Housing and Economic Recovery Act of 2008 (HERA), FHFA must ensure that the GSEs “operate in a safe and sound manner”, but it also has responsibilities to the system as a whole, to ensure that “the operations and activities [of the GSEs] foster liquid, efficient, competitive, and resilient national housing finance markets”.<sup>6</sup> The safety and soundness of the GSEs is necessary but not sufficient to meet their responsibility for the stability of the system.

The GSEs’ charter obligations are buttressed by series of federal laws, regulations and executive orders that form a strong regulatory framework aimed at ensuring non-discrimination in the housing and mortgage markets. These include the Fair Housing Act,<sup>7</sup> Equal Credit Opportunity Act,<sup>8</sup> Federal Housing Enterprises Financial Safety and Soundness Act (Safety and Soundness Act) and its implementing regulations, HERA, and several Executive Orders. The GSEs are required to meet affordable housing goals<sup>9</sup> and have a duty to serve underserved markets.<sup>10</sup> This framework and these obligations underscore the priority that Congress has placed upon fair access to housing, including mortgage lending. They represent Congress’ long-term view that all secondary mortgage market participants have an affirmative duty to further fair lending. These

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<sup>4</sup> David Min, *How Government Guarantees in Housing Finance Promote Stability*, 50 Harv. J. Legis. 437 (2013), at p. 467, available at [https://scholarship.law.uci.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1036&context=faculty\\_scholarship](https://scholarship.law.uci.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1036&context=faculty_scholarship).

<sup>5</sup> Edward Golding, Laurie Goodman and Jun Zhu, *Analysis of the Proposed 2020 FHFA Rule on Enterprise Capital*, Urban Institute (August 2020), at p. 9, available at [https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital\\_0.pdf](https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital_0.pdf).

<sup>6</sup> 12 U.S.C. § 4513(a)(1).

<sup>7</sup> 42 U.S.C. § 3601 *et seq.*

<sup>8</sup> 5 U.S.C. § 1691 *et seq.*

<sup>9</sup> 12 U.S.C. § 4561. Additionally, section 4564 describes a focus on serving “minority census tracts.”

<sup>10</sup> 12 U.S.C. § 4565.

public interest authorities and duties remain a crucial backdrop to FHFA’s consideration of the GSE capital rule.

### **III. The GSEs Are Not Banks and Should Not Be Required to Hold the Same Amount of Capital**

The driving premise behind FHFA’s proposal is that the GSEs’ capital requirements should be identical to banks, purportedly putting both types of entities on a level playing field. However, this premise is flawed. Bank capital rules are inappropriate for the GSEs and introduce needless complexity. Moreover, the proposal largely ignores the fact that banks and the GSEs are fundamentally different: 1) the GSEs’ mortgage risks are lower, 2) the GSEs receive government support through the PSPAs that banks do not that provides creditors and investors confidence that they will be paid, and 3) the GSEs are chartered to fulfill a significant and specific mission. The comparison between the GSEs and banks is thus misleading.

That the proposed rule’s aim is to treat the GSEs as banks is clear in the proposed leverage ratio plus buffer of 4%, which is the same capital requirement that banks hold for mortgage risk (a 50% risk weight on an 8% risk-weighted capital requirement). It is further manifest in FHFA’s own risk-based capital requirement. While the agency engaged in significant empirical work to determine the amount of required credit risk capital based on the experience of the GSEs through the 2008 recession, roughly two-thirds of the total risk-based capital requirement is based on subjective add-ons, through minimum capital requirements and buffers, rather than through this empirical analysis.<sup>11</sup> Because of these add-ons, the risk-based requirement emerges near the same 4% figure; as a result, it appears that the risk-based capital requirement, just like the leverage ratio, was designed to equalize capital requirements for the GSEs and banks.

Consequently, FHFA’s May 2020 proposal would raise the required capital on the GSEs’ September 30, 2019 books of business **from \$137 to \$243 billion, or by 77% over the 2018 proposal.** But because banks and the GSEs are fundamentally different in important ways, this dramatic increase in required capital is not justified.

#### **A. The GSEs’ Mortgage Risks are Less Than Banks**

The GSEs hold less risk on mortgage loans than banks do. First, the GSEs’ credit losses on mortgage loans are considerably lower than bank losses. The GSEs experience fewer losses at least partly because they are better insulated from adverse scenarios given their superior diversification of risk by geography and lender. For example, GSE single-family mortgage credit losses from 2007 forward were half that of depositories.<sup>12</sup> According to another analysis looking

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<sup>11</sup> Enterprise Regulatory Capital Framework, Comment Letter to FHFA from Andrew Davidson & Co., at p. 5 (August 2020).

<sup>12</sup> Jim Parrott, Bob Ryan and Mark Zandi, *FHFA’s Capital Rule is a Step Backward*, at p. 6, Table 4 (July 2020), available at [https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward\\_0.pdf](https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward_0.pdf).

at a longer time period (1992 through 2019, 28 years of data), Fannie Mae single-family credit loss rates were just 40% that of banks – 15 basis points compared with bank losses of 37.<sup>13</sup>

Moreover, the 50% risk weight for banks is a crude measure of risk.<sup>14</sup> It may be appropriate for banks, as mortgages are one of many types of bank assets, but it is not appropriate for the monoline GSEs. If a single risk weight *were* appropriate for the GSEs, it would be half or 40% of the banks' risk weight, based on the proportion of mortgage credit losses of the GSEs relative to banks.

Second, and more importantly, banks take on funding/liquidity, interest rate, and prepayment risks on their mortgages, while the GSEs sell off all those risks to MBS investors. Virtually all GSE mortgages are placed in MBS that are purchased by outside investors, leaving the GSEs with none of these risks to manage. By contrast, banks fund the long-term mortgages they hold with short-term deposits or debt, making the banks subject to runs on deposits or disruptions in the funding markets, and to excess prepayments if rates fall or negative interest rate spreads if rates rise, similar to what the savings and loan industry faced. These risks are significant, exceeding mortgage credit risks in potential severity over time.<sup>15</sup> While FHFA states that bank funding and interest rate risks are handled through supervision, that is not the same as transferring those risks entirely, as the GSEs do, nor is it the same as requiring capital for these risks by rule.

Further distinguishing the GSEs from banks, the PSPAs and FHFA have required the GSEs to dramatically reduce the size of their retained portfolios, which now are below \$400 billion combined and largely serve to support their credit guarantee business.<sup>16</sup>

## B. The GSEs Receive Government Support Through the PSPAs

The proposed rule requires bank-like capital, achieved through multiple buffers, in part because FHFA believes this level of capitalization is required for the GSEs to maintain MBS investor and creditor confidence.<sup>17</sup> However, the capital requirements effectively ignore the support provided

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<sup>13</sup> Enterprise Regulatory Capital Framework, Comment Letter to FHFA from Tim Howard (2020), available at <https://www.fhfa.gov//SupervisionRegulation/Rules/Pages/Comment-Detail.aspx?CommentId=15548>.

<sup>14</sup> Don Layton, *The New Proposed Capital Rule for Freddie Mac & Fannie Mae: Ten Quick Reactions*, Joint Center for Housing Studies of Harvard University (May 22, 2020), available at <https://www.jchs.harvard.edu/blog/the-new-proposed-capital-rule-for-freddie-mac-fannie-mae-ten-quick-reactions/>.

<sup>15</sup> See Edward Golding, Laurie Goodman and Jun Zhu, *Analysis of the Proposed 2020 FHFA Rule on Enterprise Capital*, Urban Institute (August 2020), at pp. 6-7, available at [https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital\\_0.pdf](https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital_0.pdf).

<sup>16</sup> If a loan in an MBS subsequently defaults, the GSE will purchase the loan out of the pool, making the investor whole, and place the loan on its retained portfolio funded by unsecured debt. The GSE will attempt to modify the loan. Over time, the GSEs reduce their retained portfolios through re-securitizations or sales of non-performing and re-performing loans, or through completed foreclosures, as they have effectively done since the crisis. Under the 2018 and 2020 proposed rules, the risk-based capital requirements appropriately take into account the market risks of the retained portfolio.

<sup>17</sup> See, e.g., 85 Fed. Reg. 39274, 39293 (June 30, 2020).

by the government – the most efficient provider of catastrophic coverage – through the PSPAs, which the GSEs will pay for through a periodic commitment fee.

Congress approved establishment of the PSPAs in 2008 under which Treasury commits to fund any net worth shortfalls in the GSEs up to a certain amount. The PSPAs provide an explicit functional government guarantee of both GSE MBS and non-MBS liabilities, which ensures global demand for the GSEs' mortgage-backed securities, keeping mortgage rates low and the 30-year fixed-rate, prepayable mortgage widely available, and ensures continued solvency of the GSEs themselves. The PSPAs' support to the GSEs is effective because they are legally irrevocable for the benefit of GSE MBS and debt holders with no expiration date. The PSPAs create binding obligations on the government so long as there are undrawn commitment amounts and MBS or debt holders to protect. If Treasury or FHFA reneged on its commitment to fund net worth deficits in the GSEs up to the remaining PSPA commitment amounts, GSE debt and MBS holders have an explicit private right of action against the government for liquidated damages to force the commitment to be met.<sup>18</sup>

The government's PSPA commitment continues whether the GSEs are in or out of conservatorship. While the PSPA support is limited, once the GSEs are capitalized to remain going concerns through another 2008 crisis, the PSPA commitment of \$254 billion is large enough to cover yet another 2008-type event, providing MBS investors strong confidence that the GSEs will be able to continue guaranteeing MBS. In fact, the GSEs have been able to maintain their market presence and play a critical countercyclical role due to PSPA support even before they built up capital. The PSPAs were effective coming through the Great Recession when the GSEs were suffering operating losses. It thus makes little sense to ignore this support in calculating the GSEs' capital needs.

Banks do not have equivalent government support. While banks have access to the discount window from the Federal Reserve and their deposit liabilities are guaranteed by Federal Deposit Insurance Corporation insurance, they do not have access to automatic infusions of net worth from the government in a crisis. A bank can fail and no longer remain a going concern, so its non-deposit creditors must derive their confidence from its level of capital instead of a government net worth guarantee.<sup>19</sup> While the GSEs should be capitalized so that failure is a remote possibility, the PSPAs permit them to continue as going concerns even in that circumstance, and their creditors and MBS investors draw their confidence from this fact.

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<sup>18</sup> See Amended and Restated PSPA (September 26, 2008), Section 6.1, pp. 8-9, available at [https://www.fhfa.gov/Conservatorship/Documents/Senior-Preferred-Stock-Agree/FNM/SPSPA-amends/FNM-Amend-and-Restated-SPSPA\\_09-26-2008.pdf](https://www.fhfa.gov/Conservatorship/Documents/Senior-Preferred-Stock-Agree/FNM/SPSPA-amends/FNM-Amend-and-Restated-SPSPA_09-26-2008.pdf).

<sup>19</sup> For a discussion of the failures of IndyMac and Washington Mutual, see David Min, *How Government Guarantees in Housing Finance Promote Stability*, 50 Harv. J. Legis. 437 (2013), at p. 478, fn 227, available at [https://scholarship.law.uci.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1036&context=faculty\\_scholarship](https://scholarship.law.uci.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1036&context=faculty_scholarship).

### **C. The GSEs Are Chartered to Fulfill a Significant and Specific Mission**

While banks have a Community Reinvestment Act obligation to serve the needs of the communities in which they are located, including the need for various forms of credit, the nature and reach of the GSEs' public mission is much more central to the fundamental operations of the GSEs than to those of banks. The GSEs' obligation to provide access to credit extends to the entire country, particularly underserved areas, including minority census tracts. Additionally, the GSEs have an explicit countercyclical mission, while banks are expected to retrench when economic conditions weaken. Lastly, while both the GSEs and banks must operate in a safe and sound manner, only the GSEs carry significant congressionally-chartered responsibility for the housing finance system as a whole.

### **D. Bank Capital Rules are Inappropriate for the GSEs and Introduce Needless Complexity**

As a result, bank capital rules are simply inappropriate for the GSEs. They also create an unnecessarily complex regulatory structure. The Basel framework is complicated because banks engage in more activities, take more types of risk, and are operationally more complex. By contrast, the GSEs are monoline, relatively simple businesses and should use a more straightforward framework. There is no need to force the GSEs to comply with a Basel structure, including the new and complex definitions of capital, each with different requirements. We also recommend that FHFA eliminate the requirement that the GSEs comply with the higher of its risk-weighted assets calculated under the standardized approach and the advanced approach using its internal model. Given that the advanced approach involves proprietary calculations, it is less transparent to the public than the approach that FHFA publishes.

## **IV. The Proposed Capital Rule Runs Counter to the GSEs' Mission**

The proposed rule runs directly counter to the public mission established in the charters of the GSEs. It would harm access to credit, undermine the GSEs' countercyclical role, and effectively reduce the safety and soundness of the GSEs and housing finance system.

### **A. The Proposed Rule Harms Access to Credit by Raising Costs Unnecessarily, Particularly for Low- to Moderate-Income Borrowers and Families of Color**

FHFA should not build an unnecessary fortress of capital around the GSEs. It is an inefficient and flawed structure that ignores the GSEs' goals to promote sustainable access to credit.

The capital requirements of the GSEs should ensure that the cost of a large-scale financial catastrophe such as the Great Recession or the current COVID-19 crisis is distributed broadly. Despite the efforts of FHFA in the proposed rule to level capital costs through imposing minimum charges on low-risk loans, the overall increase in capital requirements beyond the capital required to cover losses from a 2008-type event and remain going concerns overwhelms the leveling. The result is that borrowers would face unnecessarily higher costs and reduced

availability of mortgages. Loan level price adjustments added after the previous crisis have substantially increased costs for low- to moderate-income and lower-wealth borrowers and families of color. Instead, more level pricing should be applied to more reasonable capital standards, resulting in a substantial net decrease in the cost to these groups, in recognition of the fact that low-wealth borrowers should not be penalized for systemic risk that they did not create.<sup>20</sup>

FHFA's proposal should provide a full analysis of the effect of its capital rule on the cost of credit in different segments of mortgages since serving these markets is part of its mission. The link between capital requirements and the cost of mortgages is much less direct for banks, which hold mortgages and, at least initially, have a substantial spread between their costs of deposits and short-term funding and the mortgage rate, and which have access to many sources of non-capital intensive revenues such as fee income. Rather than having spread or fee sources of income, the GSEs are limited to earning a modest guarantee fee on the capital-intensive mortgages they buy.

As a result of the GSEs' credit guarantee model, an increase in prices due to increase in capital requirements will be direct and substantial. That is because the cost of capital to cover a catastrophic scenario is by far the largest portion of the guarantee fee charged to borrowers.<sup>21</sup> According to analysis from Mark Zandi, under normal economic conditions GSE borrowers would see rates increase by an average of 15 to 20 basis points while the GSEs remain in conservatorship.<sup>22</sup> The increase would be higher for borrowers with higher LTVs and lower credit scores – closer to 50 basis points in increased costs in a stress situation.<sup>23</sup> Analysis from Andrew Davidson & Company similarly finds that the proposal would cause an average guarantee fee increase of 14 bps.<sup>24</sup> The Urban Institute finds an increase in guarantee fees of 10 basis points just based on operation of the stability capital buffer.<sup>25</sup>

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<sup>20</sup> Marc Morial, Michael Molesky and Mike Calhoun, *Senate GSE Reform Proposal: A Blow to Affordable Housing and Harmful to the Overall Housing Market*, Center for Responsible Lending (March 2018), available at [https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-nul-senate-gse-reform-proposal\\_march2018.pdf](https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-nul-senate-gse-reform-proposal_march2018.pdf).

<sup>21</sup> Eric Stein and Bob Ryan, *Treat Fannie and Freddie as Utilities*, Center for Responsible Lending (March 2020), available at <https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-gse-utilities-report-mar2020.pdf>; FHFA, *Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2018* (December 2019) at p. 3, available at <https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GFee-Report-2018.pdf>.

<sup>22</sup> Jim Parrott, Bob Ryan and Mark Zandi, *FHFA's Capital Rule is a Step Backward*, at p. 2 (July 2020), available at [https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward\\_0.pdf](https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward_0.pdf).

<sup>23</sup> Joe Light, *Fannie-Freddie Capital Rule Seen Harming Less-Wealthy Borrowers*, Bloomberg (June 1, 2020), available at <https://www.bloomberg.com/news/articles/2020-06-01/fannie-freddie-capital-rule-seen-harming-less-wealthy-borrowers>.

<sup>24</sup> Enterprise Regulatory Capital Framework, Comment Letter to FHFA from Andrew Davidson & Co., at 14 (August 2020).

<sup>25</sup> Edward Golding, Laurie Goodman and Jun Zhu, *Analysis of the Proposed 2020 FHFA Rule on Enterprise Capital*, Urban Institute (August 2020), at pp. 8-9, available at [https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital\\_1.pdf](https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital_1.pdf).

We appreciate FHFA’s effort in the proposed rule to provide a more level application of capital requirements across risk levels, but the minimum capital requirements on low-risk loans are too high; analysis needs to be done to determine appropriate minimums such that the GSEs can remain competitive in these segments. By imposing a significantly higher risk-based capital requirement for low-risk loans, particularly in combination with a high binding leverage ratio, the proposed rule would reduce the amount of cross-subsidization that the GSEs can use to increase credit availability. The higher capital requirements for lower-risk loans would likely lead the GSEs to lose these loans to bank balance sheets and, as the market recovers, to the PLS market, because the GSEs would be required to increase their pricing for these loans.<sup>26</sup> Lacking higher returns from low-risk loans to reduce the costs of loans deemed higher-risk, the higher-risk loans would end up costing much more. As lower wealth borrowers are more likely to pay a higher share of costs and are least able to afford those costs, many would be priced out of the conventional market. This would create dual credit markets and run counter to the GSEs’ charter mission to promote access to credit throughout the nation, including central cities, rural areas, and underserved areas.

Moreover, as it currently stands, the GSEs have not been as effective as they should be at promoting access to credit for underserved borrowers and areas – particularly for communities of color. Borrowers of color, including borrowers of color with higher-incomes, are overrepresented in the FHA program, which tend to have higher costs attached.<sup>27</sup> Only 3.5% of the GSEs’ loan purchases are for mortgages made to Black borrowers and 9.2% represent Latino borrowers (Table 1). These percentages remain relatively unchanged from previous years (except for the period when the GSEs were purchasing subprime MBSs), reflecting little to no improvement in access to credit for underserved groups. The proposed rule would result in a further reduction of support for these areas that the GSEs are obliged by law to serve.

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<sup>26</sup> Brandon Ivey, *New Capital Levels to Benefit Non-Agency Market?*, Inside Nonconforming Markets (June 12, 2020) (“The average g-fee charged by the GSEs in the first quarter of 2020 was around 49 basis points. At that level, some lenders have found non-agency execution more favorable than delivering certain loans to the GSEs. For example, Bank of America retains the bulk of its GSE-eligible originations and \$3.0 billion of GSE-eligible mortgages were included in non-agency MBS issued during the first quarter of 2020, according to Inside Nonconforming Markets. Some analysts suggest if the capital requirements proposed by the FHFA take effect, the GSEs will have to increase their g-fees, which could drive more GSE-eligible originations to non-agency outlets.”).

<sup>27</sup> Peter Smith and Melissa Stegman, *Repairing a Two-Tiered System: The Crucial but Complex Role of FHA*, Center for Responsible Lending (May 2018), available at <https://www.responsiblelending.org/research-publication/repairing-two-tiered-system-crucial-complex-role-fha>.

**Table 1: Fannie & Freddie Purchase Originations, 1-4 Family**

	2018		2019	
	#	%	#	%
Black	42,093	3.50%	43,951	3.51%
Hispanic	103,422	8.59%	114,964	9.19%
Black & Hispanic Combined	145,515	12.09%	158,915	12.70%
All Races (including "Unknown"** and "N/A")	1,203,642	100.00%	1,250,992	100.00%

National Fair Housing Alliance – Source: Lending Patterns

\*In 2019, race was reported as "Unk" on 12.10% of purchase originations; and in 2018, race was reported "Unk" on 11.23% of purchase originations.

As the proposed rule would reduce the GSEs' support for mortgage access for underserved groups and severely limit credit options for these borrowers, many families of color would be pushed to lender portfolio programs or government programs like FHA. However, it is not certain that these borrowers would in fact be able to obtain loans using these alternate vehicles. Lenders are limited in the number of loans they can hold on their own books. Moreover, FHA has implemented policies that require certain loans be manually underwritten and lenders are reluctant to engage in manual underwriting. The proposed rule would not only result in underserved borrowers being steered to non-conventional mortgages, but would restrict credit access and increase costs for a group of borrowers that have had unduly limited credit access, largely because of historic and continuing discrimination.<sup>28</sup>

### B. The Proposal is Counter to the GSEs' Countercyclical Mission

The proposed rule constrains the GSEs in fulfilling their countercyclical mission in a crisis. The unjustified increase in costs imposed by the proposed rule would shrink the GSEs' nationwide scope by causing market share to shift, with low-risk loans moving to banks and PLS and loans of borrowers with lower credit scores and higher LTVs pushed to FHA.

According to one estimate, the GSEs would contract from approximately 45% of the mortgage market to about a third of the market, losing 10 to 14 percentage points of origination market share on average through the business cycle.<sup>29</sup> With a smaller footprint, the GSEs would provide

<sup>28</sup> See Section V for more information regarding the federal government's role in restricting credit access for borrowers of color.

<sup>29</sup> Jim Parrott, Bob Ryan and Mark Zandi, *FHFA's Capital Rule is a Step Backward*, at p. 3 (July 2020), available at [https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward\\_0.pdf](https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward_0.pdf); Urban

less countercyclical support. As the country experienced during the Great Recession and the current COVID-19 crisis, private markets tend to retract during times of stress, serving only borrowers with the most pristine credit profiles. Additionally, because any GSE capital rule will likely continue to be pro-cyclical to some degree, the GSEs will need to raise capital just to maintain their current lower volumes, not to mention to fill gaps, and it will be nearly impossible for the GSEs to raise external capital in a crisis.

This inherent problem is significantly exacerbated by the proposed stability capital buffer, which imposes punitive marginal capital requirements on the GSEs for increasing their market share. While the first 5% of market share is free of capital charge, each GSE would face a 5 basis points charge for each percentage point above. For example, currently Fannie Mae has a 26% share, which leads to a 105 basis points capital requirement. As the Urban Institute discusses in its paper, this approach is procyclical and disincentivizes the GSEs from even attempting to fill the gap when private capital retreats in a crisis and GSE purchases are needed most, likely increasing mortgage rates by another 10 bps.<sup>30</sup>

### C. The Proposed Rule is Counter to Systemic Safety and Soundness

It is fundamental that the GSEs must operate in a safe and sound manner. But safety and soundness for the GSEs should not be viewed as an end in and of itself, but as part of a framework to achieve the GSEs' mission and goals.

Building a fortress of capital around the GSEs does not ensure safety and soundness in the housing finance system. Rather, it would make risk more concentrated and the system overall more volatile. While some have argued for reducing the market share of the GSEs to spread risk and market power more broadly through the housing finance system, here it would produce the opposite result. Loans that could be safely guaranteed by Fannie and Freddie, which are funded by private MBS investors and whose credit risk would be largely taken by private credit risk transfer investors and mortgage insurers, would instead go to FHA, which is 100% government guaranteed, or to banks, which retain all the risks. And with less incentive to do CRT, the GSEs would hold more risk than they do today. Assuming the rule's disincentives to CRT are later applied to mortgage insurers through PMIERS, mortgage insurance companies, which engage in their own CRT transactions to private investors, would also concentrate more risk rather than distributing it as well. Consequently, the rule would leave the market more, not less, concentrated, with risk that is currently spread among a wide range of MBS and CRT investors concentrated among the GSEs, a few banks and FHA.

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Institute, Housing Chartbook (June 2020), <https://www.urban.org/sites/default/files/publication/102475/june-chartbook-2020.pdf>.

<sup>30</sup> Edward Golding, Laurie Goodman and Jun Zhu, *Analysis of the Proposed 2020 FHFA Rule on Enterprise Capital*, Urban Institute (August 2020), at pp. 8-9, available at [https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital\\_1.pdf](https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital_1.pdf).

And by shrinking the GSEs' market share, more of the market would be vulnerable to swings in the private market. As we have seen through every cycle in recent decades, the market outside the government footprint expands quickly in good times and disappears altogether in times of stress. By turning a larger share of the system over to this segment of the market, these swings would make the system overall more volatile.

## V. As Proposed, the Capital Rule Would Exacerbate the Already Large Racial Wealth Gap

Today's racial wealth gap and lending disparities are in large part the result of decades of government policies and practices that enabled the redlining of communities of color for most of the 20th century. In the post-Depression era, federal policies that created housing opportunities for returning veterans and their families explicitly excluded people of color from the benefits of government-supported housing programs. Among these programs were public housing, the Home Owners Loan Corporation (HOLC), and mortgage insurance through the Federal Housing Administration (FHA).<sup>31</sup> Not only did this redlining segregate residential neighborhoods across the United States, but it granted whites the ability to build wealth through homeownership while denying equal opportunities for families of color to build similar home equity over the same period. As a result, whites accrued an economic advantage in the form of home equity that has been passed on to future generations through intergenerational wealth transfers.

Homeownership remains key to wealth accumulation and buying a home is the largest investment most families make. For Black families, this is particularly true: homeownership amounts to 53% of wealth for Black families versus 39% for white families.<sup>32</sup> There continues to be a stark disparity in the homeownership rate between whites and people of color. The white homeownership rate is 73% while the rate is 44% and 48% for Black and Latino borrowers respectively.<sup>33</sup> Additionally, the Great Recession exacerbated inequality in homeownership rates and wealth distributions. The decline in homeownership that followed the Great Recession wiped out thirty years of homeownership gains among Black Americans and substantially reduced the

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<sup>31</sup> See, e.g., HOLC "Redlining" Maps, *The Persistent Structure of Segregation and Economic Inequality*, NCRC (2018), available at <https://ncrc.org/holc/>. The study examined how neighborhoods were evaluated for lending risk by the HOLC and compares their recent social and economic conditions with city-level measures of segregation and economic inequality. Neighborhoods considered high risk or "Hazardous" were often "redlined" by lending institutions, denying them access to capital investment which could improve the housing and economic opportunity of residents. Redlining buttressed the segregated structure of American cities. Most of the neighborhoods (74%) that the HOLC graded as high-risk or "Hazardous" eight decades ago are low-to-moderate income today. Additionally, most of the HOLC graded "Hazardous" areas (nearly 64%) are predominately communities of color today.

<sup>32</sup> Thomas Shapiro, Tatjana Meschede, and Sam Osoro, *The Roots of the Widening Racial Wealth Gap: Explaining the Black-White Economic Divide*, Brandeis University Institute on Assets and Social Policy (Feb. 2013), available at <https://heller.brandeis.edu/iasp/pdfs/racial-wealth-equity/racial-wealth-gap/roots-widening-racial-wealth-gap.pdf>.

<sup>33</sup> See Jung Hyun Choi, Alanna McCargo, Michael Neal, Laurie Goodman and Caitlin Young, *Explaining the Black-White Homeownership Gap: A Closer Look at Disparities across Local Markets*, Urban Institute (November 2019), available at [https://www.urban.org/sites/default/files/publication/101160/explaining\\_the\\_black-white\\_homeownership\\_gap\\_2.pdf](https://www.urban.org/sites/default/files/publication/101160/explaining_the_black-white_homeownership_gap_2.pdf); Sarah Strochak, Caitlin Young and Alanna McCargo, *Mapping the Hispanic Homeownership Gap*, Urban Institute (August 2019), available at <https://www.urban.org/urban-wire/mapping-hispanic-homeownership-gap>.

homeownership rate among Latinos. Moreover, Black and Latino families lost over \$1 trillion dollars in wealth during the crisis.<sup>34</sup> Many families, disproportionately families of color, never fully recovered from the Great Recession and are now facing further strain from the COVID-19 public health and economic crisis.

As a result of homeownership disparities, discrimination, and lack of fair access, the racial wealth gap continues to grow. The median white family has 10 times the wealth of the median Black family and 8 times the wealth of the median Latino family.<sup>35</sup> Moreover, the median Black household with children has 1% of the wealth of the median white household with children.<sup>36</sup> Indeed, wealth required for down payment and closing costs is a major barrier to home ownership for families of color. Nine out of ten Black homeowners cover their down payments from their own savings, while white households are three times more likely to rely on family assistance.<sup>37</sup>

Today's racial homeownership disparities and wealth gaps are driven by the decades-long exclusion of families of color from accessing mortgage credit and building home equity. It is imperative that public policies, including the GSE capital rule, do not perpetuate the harms of the past.

## **VI. Specific Recommendations**

### **A. Elements of the Rule Should be Retained**

The proposal does make some improvements to the 2018 proposed rule that should be retained. The 2020 proposed rule reduces penalties for lower-wealth borrowers by removing the surcharge for single borrower loans and for low balance loans, defined as mortgages below \$100,000. The surcharge for single borrower loans would have penalized single-parent households trying to achieve home ownership for the benefit of their families and the one for small loans would have raised costs in rural and depressed markets. Both these surcharges likely would have created a

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<sup>34</sup> Debbie Gruenstein Bocian, Peter Smith, and Wei Li, *Collateral Damage: The Spillover Costs of Foreclosures*, Center for Responsible Lending (Oct. 24, 2012), available at <https://www.responsiblelending.org/mortgage-lending/research-analysis/collateral-damage.pdf>.

<sup>35</sup> Asset Building Policy Network, *The Hispanic-White Wealth Gap Infographic* (September 2019), available at [https://prosperitynow.org/sites/default/files/resources/ABPN\\_Hispanic\\_White\\_Racial%20Wealth%20Gap%20Infographic\\_Final.pdf](https://prosperitynow.org/sites/default/files/resources/ABPN_Hispanic_White_Racial%20Wealth%20Gap%20Infographic_Final.pdf); Nick Noel, Duwain Pinder, Shelley Stewart III, and Jason Wright, *The Economic Impact of Closing the Racial Wealth Gap*, McKinsey & Company (August 2019), Exhibit 1 at p. 5, available at <https://www.mckinsey.com/industries/public-and-social-sector/our-insights/the-economic-impact-of-closing-the-racial-wealth-gap>.

<sup>36</sup> Christine Percheski and Christina Gibson-Davis, *A Penny on the Dollar: Racial Inequalities in Wealth Among Households with Children* (June 1, 2020), available at <https://journals.sagepub.com/doi/full/10.1177/2378023120916616>.

<sup>37</sup> Thomas Shapiro, Tatjana Meschede, and Sam Osoro, *The Roots of the Widening Racial Wealth Gap: Explaining the Black-White Economic Divide*, Brandeis University Institute on Assets and Social Policy (Feb. 2013), available at <https://heller.brandeis.edu/iasp/pdfs/racial-wealth-equity/racial-wealth-gap/roots-widening-racial-wealth-gap.pdf>; Thomas Shapiro, *The Hidden Costs of Being African American: How Wealth Perpetuates Inequality* (2004), at pp. 113-14.

disparate impact based on race and sex. Analysis from our 2018 comment demonstrated that these additional costs were unjustified, as they overstated stress losses and raised credit risk capital and costs beyond what is necessary.<sup>38</sup>

The proposal dampens the pro-cyclicality of the 2018 proposal’s use of mark-to-market LTVs (MTMLTV) for risk-based capital to some degree. The proposed rule retains the 2018 proposal’s approach to using updated home values to establish the MTMLTV of single-family mortgage exposures, which may cause significant variability in determining capital requirements – resulting in potentially too little capital at the peak of the cycle while likely necessitating substantially higher capital requirements at the trough of the cycle. The proposed rule reduces the procyclicality of the 2018 proposal by including a countercyclical adjustment that would take effect if house prices are more than 5% greater or less than an inflation-adjusted long-term trend. This is a helpful approach, although we believe FHFA should undertake more dynamic analysis of it. As discussed in Urban Institute’s paper, FHFA could consider a wider and asymmetric collar.<sup>39</sup> Additionally, FHFA should factor in home price volatility across the country and consider regionalizing the countercyclical adjustments.<sup>40</sup>

Similar to the 2018 rule’s going concern buffer, the proposed rule’s 75 basis point stress capital buffer is reasonably sized, funding one to two years of purchases, and correctly risk invariant. (While we do not support the existence of the other buffers, we do support the fact that they are also risk-invariant.) The proposal improves on the 2018 proposal by indicating that if capital falls below required buffer amounts, the GSEs do not violate the capital rules but instead are prohibited from making capital distributions or bonus payments. However, this is only a marginal improvement since the GSEs will want to be able to pay dividends and bonuses. Lastly, we agree with moving from a 30-day delinquency to a 60-day delinquency measure on determining credit risk capital requirements since many low-wealth families will have occasional 30-day delinquencies, yet not default.

Finally, as discussed in section IV.A., we appreciate FHFA’s attempt to provide a more level application of capital requirements across risk levels. However, the combination of excessive overall capital requirements, so that there is no actual reduction in capital requirements for loans considered higher risk,<sup>41</sup> and a low-risk minimum that is too high, would result in net increases in costs for lower-wealth families.

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<sup>38</sup> Enterprise Regulatory Capital Framework, Comment Letter to FHFA from Center for Responsible Lending (November 2018), available at <https://www.responsiblelending.org/research-publication/comments-enterprise-capital-requirements-fhfa-rin-2590-AA95>.

<sup>39</sup> Edward Golding, Laurie Goodman and Jun Zhu, *Analysis of the Proposed 2020 FHFA Rule on Enterprise Capital*, Urban Institute (August 2020), at p. 18, available at [https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital\\_1.pdf](https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital_1.pdf).

<sup>40</sup> Jim Parrott, Bob Ryan and Mark Zandi, *FHFA’s Capital Rule is a Step Backward*, at p. 7 (July 2020), available at [https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward\\_0.pdf](https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward_0.pdf).

<sup>41</sup> See Enterprise Regulatory Capital Framework, Comment Letter to FHFA from Andrew Davidson & Co., at 10 (August 2020).

## **B. FHFA Should Count a Portion of Guarantee Fee Revenue as Capital for Risk-based Capital Requirements**

Capital requirements should take into account ongoing GSE guarantee fee revenues, which were proven to provide reliable and substantial loss absorbing capacity in the 2008 financial crisis. During this period, fully 92% of GSE borrowers stayed current on their loans. Guarantee fees provide offsetting revenues that the GSEs earn and provide loss coverage, preserving capital levels, so logically they should count toward capital requirements.<sup>42</sup> If it were true that revenues have no impact on required capital, then it would follow that the same amount of paid-in capital should be required if guarantee fees were 5 basis points or 500 basis points; clearly, the higher guarantee fees would protect the paid-in capital from having to cover losses more than the lower fees.

Two examples of uses of guarantee fees that do count toward capital demonstrate why guarantee fees themselves should count. First, guarantee fee income used to purchase loss protection through CRT transactions appropriately reduces paid-in capital requirements, while guarantee fees directly available to cover losses do not. Second, if the GSEs created and sold interest-only (IO) strips of guarantee fee revenue, the proceeds would count toward capital (although given the GSEs would have transferred the prepayment risk to investors, if they kept their guarantee fee revenues and retained this risk they would need to discount the amount that counts as capital). Ignoring these fees in capital calculations encourages the GSEs to create IO securities and bear deadweight transaction costs.

As a result of the economic reality that revenues cover losses before capital does, bank capital requirements recognize revenue through the Dodd-Frank stress tests, as do the GSEs' stress tests. The significance of these revenues is clear from the GSEs' most recent stress tests. According to the August 15, 2019 annual Dodd-Frank Act Stress Tests, using roughly the same "severely adverse scenario" that banks use, the combined GSEs showed two losses: \$18 billion and \$43 billion, depending on the open question of whether the GSEs would need to create allowances related to their deferred tax assets or not.<sup>43</sup> Assuming they would have to, these losses would still constitute less than 1% of total GSE assets. As Don Layton points out, the \$243 billion proposed capital requirement appears excessive in light of these stress tests that do factor in revenues: 13.5 times greater than the calculated loss using the \$18 billion loss, and 5.6 times greater when using the \$43 billion figure.<sup>44</sup>

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<sup>42</sup> See Enterprise Regulatory Capital Framework, Comment Letter to FHFA from Mike Molesky, available at <https://www.fhfa.gov//SupervisionRegulation/Rules/Pages/Comment-Detail.aspx?CommentId=15587>, for a discussion of the importance of considering revenues in setting capital requirements, as well as the importance of better-performing vintages of seasoned loans to offset losses from high-loss years.

<sup>43</sup> See FHFA, *Dodd-Frank Act Stress Test Results, Severely Adverse Scenario* (August 15, 2019) at pp. 6-8, available at [https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2019\\_DFAST\\_Severely-Adverse-Scenario.pdf](https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2019_DFAST_Severely-Adverse-Scenario.pdf).

<sup>44</sup> Don Layton, *The New Proposed Capital Rule for Freddie Mac & Fannie Mae: Ten Quick Reactions*, Joint Center for Housing Studies of Harvard University (May 22, 2020), available at <https://www.jchs.harvard.edu/blog/the-new->

The fact that capital levels were insufficient before the crisis led to guarantee fees that were underpriced and therefore significantly inadequate to cover losses. Counting revenues as the current stress tests do demonstrates the protection that adequately priced guarantee fees provide.

At minimum, two- or three-years' worth of future guarantee fees (consisting of less than half the average life of a mortgage), less general and administrative expenses, should count toward capital requirements.

### **C. FHFA Should Treat Properly Discounted CRT as a Component of Required Credit Risk Capital**

In FHFA's risk-based capital proposal, it first calculates the total amount of underlying credit risk capital required for a given book of business. Second, it considers the effectiveness of any CRT and mortgage insurance in transferring risk and the need to "haircut" the benefits for risk exposures retained, such as counterparty risk, length of coverage, and attachment/detachment points. Through this analysis it determines the net benefit of this transfer of risk, which can be thought of as an equity-equivalent form of capital. Third, FHFA subtracts this reduced CRT and MI coverage from the amount of underlying credit risk capital required to arrive at the final amount of required credit risk capital. Fourth, it includes additional capital requirements for operational risk, market risk, and buffers, to arrive at the total risk-based capital required.

We suggest an alternative way to handle CRT and credit risk capital that would come to the exact same substantive result in a more transparent way. Total mortgage credit risk capital would be established by the first step. Then FHFA would consider properly haircut CRT and MI as a *component of capital* rather than a *reduction in the amount of credit risk capital required*. As a result of this approach, the nominal amount of required credit risk capital would be higher than in FHFA's proposed rule by the amount of permitted CRT and MI coverage, but the amount of paid-in capital required would not change.

Such an approach would more transparently communicate the amount of risk the GSEs are taking and how the GSEs will address this risk. Since the proposed rule does not take this approach, its comparisons of the credit risk requirements of the GSEs and banks are not apples to apples, because it compares post-CRT exposure by the GSEs with pre-CRT exposure by the banks, which largely do not use CRT.

In addition, FHFA should provide more credit to CRT than it does in the proposed rule. While FHFA is correct that CRT is not as effective as equity in absorbing losses, as CRT is limited to a particular vintage while equity is not, the proposed rule provides too little credit for CRT. In particular, it should not require a 10% minimum level of capital even for catastrophic exposure, which it appropriately does not require for exposure without CRT, and the leverage ratio should be much lower, serving as a backstop to the risk-based capital requirement and not as a substitute

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proposed-capital-rule-for-freddie-mac-fannie-mae-ten-quick-reactions/. The stress tests measure losses over a nine-quarter period.

for it. FHFA's analysis of the September 30, 2019 single-family book demonstrates that the GSEs would have received \$27 billion of capital relief under the 2018 proposed rule, and \$11 billion under the current proposal.<sup>45</sup> Limiting the GSEs' ability to utilize CRT to reduce capital requirements is likely to increase capital costs and lead to further increases in guarantee fees. Moreover, the likely application of FHFA's approach to CRT to PMIERS would also further perpetuate risk-based pricing and substantially increase the cost of mortgage insurance, required for lower-wealth families, which are disproportionately families of color.

#### **D. The Proposed Rule Should Eliminate the Punitive Stability Capital Buffer and the Countercyclical Capital Buffer**

As discussed in section VI.D., the stability buffer is punitive and runs counter to the GSEs' countercyclical mission. It should be eliminated. Further, rather than impose a countercyclical capital buffer category through rulemaking, as described in the 2018 proposed rule, FHFA has sufficient authority under the Safety and Soundness Act, by order or regulation, to increase risk-based and leverage capital requirements as needed, negating the need to impose a specific countercyclical buffer.

#### **E. FHFA Should Lower the Leverage Ratio to the Alternative Proposal from the 2018 Proposed Rule of 1.5% for Trust Assets and 4% for Retained Portfolio**

As discussed, the high and binding leverage ratio of the proposed rule would increase costs needlessly. The requirement is taken from bank capital requirements and, as described in section III, based on the false premise that the GSEs act like banks. Additionally, based on the current governing statute, guarantee fees and CRT cannot count toward the leverage ratio. FHFA should take this into account by reducing the leverage ratio to serve as a backstop covering possible misestimation or modeling error in the risk-based capital requirement.

Rather than a flat 2.5% leverage requirement supplemented by a 1.5% buffer, FHFA should eliminate the buffer and adopt a 1.5% requirement for trust assets and 4% for retained portfolio assets where the GSEs in fact act more like banks. This proposal was an alternative presented in the 2018 rule.

#### **F. FHFA Should Regulate the GSEs as Utilities**

While we recognize that utility regulation is outside the scope of the proposed rule, it is a contemporaneous decision FHFA must make in working to release the GSEs from conservatorship and, along with the level of required capital imposed by FHFA through its capital rule, will help determine the level of guarantee fees through the permitted return on equity.

Outside of conservatorship the GSEs should be regulated as utilities by limiting their overall return on equity to a target band sufficient to attract the necessary private investment capital; to

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<sup>45</sup> 85 Fed. Reg. at 39349 (Table 26).

the same functional effect, FHFA could retain the ability to control guarantee fees out of conservatorship. This idea is broadly supported.<sup>46</sup> In conservatorship, FHFA determines the assumed return on its required implicit capital, currently based on the 2018 proposed capital rule. Out of conservatorship, FHFA and Treasury should establish retention of this authority in the documents that release the GSEs from conservatorship.

Under an approach similar to the regulation of electric utility companies, FHFA would limit the rate of return that the GSES can earn, ensuring that its return on equity is neither too high, which unnecessarily harms borrowers, nor too low, which threatens the GSEs' safety and soundness through a race to the bottom. Given the fact that the GSEs are a duopoly with significant economies of scale and advantages provided by the government, and that they provide essential services to the country, they should not be permitted to maximize returns, just as utility companies should not be permitted to gouge customers on the price of electricity. In both cases, the regulator would permit investors earn a "fair" return given the risks they are taking on, but not an excessive one. By contrast, the GSEs' returns on equity generally exceeded 20% from 1992 until the financial crisis, leading them to take on excessive risk.

Indeed, duopolies are rarely stable. One of two outcomes is most likely at any particular time: 1) there will be downward pressure to cut prices to earn market share, threatening each entities' safety and soundness, or 2) there will be upward pressure through implicit collusion by the two entities to raise consumer prices to an unnecessarily high level. Utility regulation protects against both risks.

If the GSEs were regulated as utilities, investors would recognize that the GSEs' current low-risk business model would continue and view GSEs as value stocks with sustainable dividend capacity, requiring lower ROEs. In contrast, removing controls on GSE returns on equity would lead to less pooling of risk among borrowers, more segmented risk-based pricing, more risk-taking to maximize returns, higher prices for America's homebuyers as the GSEs exploit their

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<sup>46</sup> See Eric Stein and Bob Ryan, *Treat the GSEs as Utilities*, Center for Responsible Lending (March 2020), available at <https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-gse-utilities-report-mar2020.pdf>; Richard Cooperstein, Ken Fears, and Susan Wachter, *Working Paper: A Vision for Enduring Housing Finance Reform*, The National Association of REALTORS®, (February 7, 2019) at pp. 22–29, available at <https://www.nar.realtor/sites/default/files/documents/2019-Working-Paper-A-Vision-For-Enduring-Housing-Finance-Reform.pdf>; Don Layton, *Why is the Administration not Talking About Utility-Style Regulation of G-fees?*, Joint Center for Housing Studies of Harvard University (July 16, 2019), available at <https://www.jchs.harvard.edu/blog/why-is-the-administration-not-talking-about-utility-style-regulation-of-g-fees/>; *Treasury Secretary Paulson on the Role of the GSEs in Supporting the Housing Recovery*, at p. 8 (January 7, 2009), available at [https://www.economicclub.org/sites/default/files/transcripts/paulson\\_transcript%20JF%20Revision.pdf](https://www.economicclub.org/sites/default/files/transcripts/paulson_transcript%20JF%20Revision.pdf) ("[E]stablishing a public utility-like mortgage credit guarantor could be the best way to resolve the inherent conflict between public purpose and private gain. Under a utility model, Congress would replace Fannie Mae and Freddie Mac with one or two private-sector entities. The entities would purchase and securitize mortgages with a credit guarantee backed by the federal government and would not have investment portfolios. These entities would be privately owned, but governed by a rate-setting commission that would establish a targeted rate of return, thereby addressing the inherent conflicts between private ownership and public purpose that are unresolved in the current GSE structure.").

duopoly status, and more restricted access to credit nationwide. The result would be a further widening of already large homeownership disparities and the racial wealth gap and a reduction in the GSEs' long-term safety and soundness and systemic stability.

## **Conclusion**

The proposed capital rule conflicts with the GSEs' charter mission by treating the GSEs as banks. As a result of this approach, the rule would unnecessarily increase the cost of mortgage credit with a disproportionate impact on low- to moderate-income borrowers and borrowers of color. Furthermore, the rule would make it impossible for the GSEs to play their critical countercyclical role in a crisis. Lastly, overcharging for capital does not create a safer marketplace. Rather, the proposal would redistribute and concentrate risk in the housing finance system. The proposed rule should be revised to comply more appropriately with the GSEs' mission.