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National Association of Federally-Insured Credit Unions

August 31, 2020

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
400 7th Street SW
Washington, D.C. 20024

RE: Enterprise Regulatory Capital Framework Re-proposal

Dear Mr. Pollard:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing in response to the regulatory capital framework for Fannie Mae and Freddie Mac (the GSEs) re-proposed by the Federal Housing Finance Agency (FHFA). NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve 121 million consumers with personal and small business financial service products. NAFCU has long supported the goal of allowing the GSEs to rebuild appropriate capital buffers and to exit conservatorship into a healthy, sustainable secondary mortgage market. NAFCU appreciates the re-proposal of this capital requirements rule and urges the FHFA to adopt a realistic capital framework for the GSEs to begin moving toward exiting conservatorship. However, the FHFA should work with lawmakers to ensure certain legislative guarantees are adopted before the GSEs are released from conservatorship to guarantee access for smaller lenders like credit unions.

NAFCU has urged Congress to take up housing finance reform efforts including establishing guaranteed access to the secondary market, issuing an explicit government guarantee on the payment of MBS, and establishing an equitable framework for alternative participants to compete with the GSEs in the secondary market. Until Congress acts, the GSEs should move towards becoming stable and self-funded, without relying on their U.S. Department of the Treasury lines of credit. A regulatory capital framework that ensures the long-term future of the GSEs and the protection of American taxpayers is a necessary component of that goal.

It is critical that the FHFA establish a robust capital framework that seeks to prevent another government bailout in the event of a severe stress event similar to the 2008 financial crisis. However, it is just as critical that capital levels are not set too high, which could impact fees charged to smaller lenders, making it harder to access the secondary market. Capital in the housing finance system must also be effectively deployed to ensure affordable housing is available for American consumers. Similarly, the FHFA must ensure its capital framework aligns with actual risks posed and appropriate reductions of that risk. Over-capitalizing the GSEs, over-estimating the risks of certain loans, and undervaluing credit risk transfer mechanisms will only serve to harm

underserved, low-income and moderate-income consumers and the credit unions which exist to serve them.

The Impact of Increased Guarantee Fees on Credit Unions and Vulnerable Consumers

NAFCU and its member credit unions appreciate the opportunity to provide further input on the GSEs' regulatory capital framework. The initial proposal relied on the Basel capital standards for commercial banks and other banking capital frameworks as points of comparison in determining appropriate capital levels. This resulted in a strong capital regime that likely aligned with international banking standards. In an effort to address pro-cyclicality concerns, it appears the FHFA has departed from these frameworks in key areas to establish a capital framework appropriate for an institution with the size and complexity of an international commercial bank that will also be capitalized such that it is entirely unaffected by cyclical trends.

The Impact of Over-Capitalization on the Cost of Credit

The proposal would increase the required capital on the GSE's September 30, 2019 book of business by 77 percent compared to the June 2018 proposal and current capital requirements under conservatorship. The capital reserve requirements that result from the re-proposal are vastly higher than necessary. As drafted, the re-proposal would likely establish capital levels that exceed the worst-case loss scenarios developed by the Federal Reserve. In addition, in June the FHFA issued new guidance to the GSEs updating their liquidity requirements, requiring the GSEs to hold liquid assets in line with the largest banks. The combination of higher liquidity requirements and excessive capital requirements leaves little room for the GSEs to generate income and present an attractive return on investment to private investors. The FHFA must strike the proper balance to ensure the GSEs are stable, but still able to raise private capital and able to safely exit conservatorship without risking the money of American taxpayers.

The proposed capital requirements are out of line with the actual risks posed by the GSEs' activities, which have shifted significantly since 2008. Over the first half of 2020, only 3.68 percent of the GSEs' combined book of business consisted of mortgages held in portfolio.[1] The vast majority of the GSEs' current business is in providing guarantees. These activities are more akin to that of an insurance company than an international commercial bank, so their capital requirements should be set accordingly to align with their activities.

The potential harms of setting capital levels too high are significant for credit unions. As member-owned, not-for-profit cooperatives, credit unions have a long history of offering products and services to low-income, moderate-income, and underserved consumers that have been turned away by banks. Increases in the cost of credit in the form of increased guarantee fees (g-fees) and mortgage rates would have a significant negative impact on credit unions' ability to serve these less-wealthy members.

[1] *See*, Fannie Mae, Monthly Summary June 2020, https://www.fanniemae.com/resources/file/ir/pdf/monthly-summary/063020.pdf; Freddie Mac, Monthly Volume Summary: June 2020, http://www.freddiemac.com/investors/financials/pdf/0620mvs.pdf.

The Re-proposal Does Not Ensure Housing Finance Access for Vulnerable Borrowers

If capital requirements are too high, it will increase the cost of mortgage credit across the system, and this effect must be considered. If the FHFA has performed its own analysis on the potential increase to the cost of credit as a result of the re-proposal, it has not shared that analysis with the public. The FHFA should conduct a thorough analysis of these outcomes before finalizing the rule. The data and results of that analysis should be included in the preamble to the final rule or a supplemental document to provide transparency to the mortgage servicing industry and borrowers. If finalized as written, the capital framework could result in an increase in mortgage rates between 15 and 25 basis points.[2] This type of increase will be most severely experienced by potential borrowers with lower income and/or credit scores.

NAFCU supports vibrant competition among market participants in the secondary market. However, this competition should be the result of invocation where participants compete on technology, customer service, and other services. It should not be competition based on a "race to the bottom." While the increase in g-fees resulting from FHFA's capital rule may serve to forcibly increase competition for the GSEs, allowing the FHFA to pursue this policy goal administratively in the absence of Congressional reform of the housing finance system, it does so to the detriment of vulnerable borrowers. Fostering competition by increasing the cost of credit leaves underserved, low-income or moderate-income borrowers to bear the burden of that policy achievement. Pushing these consumers out of access to homeownership in order to create competition in the secondary market would be completely at odds with the GSEs' obligations to serve low-income, moderate-income, and underserved families and to support affordable housing preservation under the *Federal Housing Enterprises Financial Safety and Soundness Act* and the *Housing and Economic Recovery Act of 2008*.

More could be done to ensure access to housing finance for these borrowers. NAFCU appreciates the FHFA's recent efforts to incorporate alternative credit scores, including the recent publication of the Joint Credit Score Solicitation permitting developers of alternative credit scores to apply for validation and approval with the GSEs. While this is a multi-year effort, it provides critical benefit to low- and moderate-income borrowers who may have no or a low FICO score but are nonetheless credit-worthy. To that same point, the FHFA must ensure that appropriate cross-subsidies for low- and moderate-income borrowers remain in place and are not distorted by capital requirements. Pricing of credit risk-based cross-subsidies should reflect the actual credit risk posed by the loan, and not simply their Classic FICO score. The FHFA should critically evaluate the quality of the data used to develop these capital standards and modeling of mortgage performance to better align the proposed capital requirements with actual risk.

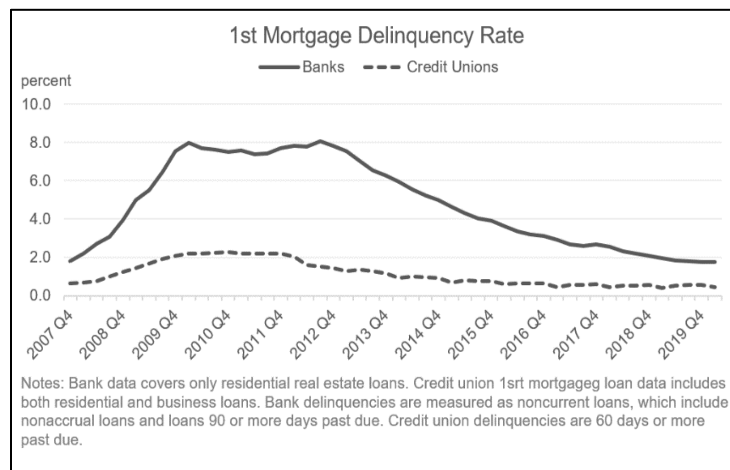
Credit Union-Originated Mortgages Should Receive Base Risk Weight Discounts

The FHFA's re-proposed capital framework determines base risk weights for single-family mortgage exposures based solely on the credit score and the mark-to-mortgage loan-to-value

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

(MTMLTV). NAFCU urges the FHFA to consider an adjustment of the base risk weight for mortgages originated by credit unions to account for the high quality and historically strong performance of those loans, or at least an adjustment for all lower-risk originator classes.

Over the past 50 quarters, the delinquency rate of mortgages made by banks has averaged 4.79 percent.[3] During the same period, the average rate of delinquency on mortgages originated by credit unions is 1.14 percent according to available Call Report data.[4] At the height of the 2008 financial crisis, bank delinquency rates hit 8.08 percent in the third quarter of 2012[5] whereas delinquencies on credit union mortgages peaked at 2.28 percent in the fourth quarter of 2010.[6]



On average, the delinquency rate of bank-originated mortgages is four-times that of a credit union-originated mortgage. This proportional difference holds under various levels of stress on the housing market and the economy. The disparity is the direct result of credit unions' conservative underwriting practices and the distinct nature of their relationship with their members. Credit union-originated mortgages are significantly and demonstrably a lower-risk investment for the GSEs and this should be reflected in pricing and the capital framework.

Lower capital requirements attached to these mortgages should translate to a risk-adjusted pricing structure for credit unions. The regulatory capital framework should include a discount for these especially low-risk credit union mortgages in the base risk weight grid for performing and reperforming single-family mortgage loans. This will incentivize the GSEs to purchase high-quality loans from credit unions and ensure that the cost of credit remains low, allowing credit unions to continue to serve low-income, moderate-income, and underserved borrowers. Those savings should be passed on in the form of lower g-fees for credit unions selling mortgage loans to the GSEs through the cash-window or through MBS executions. This risk-adjusted pricing

[3] *See*, FDIC Aggregate Time Series Data.
[4] Bank data covers only residential real estate loans. Credit union first mortgage loan data includes both residential and business loans. Bank delinquencies are measured as noncurrent loans, which include nonaccrual loans and loans 90 or more days past due. Credit union delinquencies are 60 days or more past due.
[5] *See*, FDIC Aggregate Time Series Data.
[6] *See*, NCUA Call Report Data.

would support the GSEs' goal of ensuring affordable housing and incentivize the origination and sale of high-quality credit union mortgage loans.

The categorical lower risk of credit union-originated mortgages is real and it is measurable. It should be accounted for in the regulatory capital framework. The FHFA should provide capital relief for Fannie Mae and Freddie Mac by reducing the amount of capital that must be reserved against credit union-originated mortgage loans, or for all lower-risk originator classes, and providing risk-adjusted pricing for those loans.

Devaluation of Credit Risk Transfers

It is critical that the FHFA establish a robust capital framework that seeks to prevent another government bailout in the event of a severe stress event like the 2008 financial crisis. The transfer of risk to the private sector is important to achieving that goal. As the GSEs begin to raise capital, it is critical that privatization of the GSEs happens gradually, rather than all at once, and with an eye toward ensuring continued access for credit unions and other small, community-based financial institutions and affordable housing for all borrowers. As that gradual transition occurs, the GSEs must continue to make consistent use of risk transfer mechanisms to put private capital in front of tax-payer exposure. This should include both credit risk transfer (CRT) transactions and private mortgage insurance (PMI).

The re-proposal's treatment of CRT provides little corresponding reduction of capital. Further, it approaches risk transfer via PMI significantly more favorably that CRT. It appears the FHFA intends to discourage the GSEs from continuing to make strong use of CRTs by making these transactions uneconomical. Further, by discounting the value of CRT so heavily in the re-proposal, it also disregards the role of CRT in the transitional period until the GSEs can be fully moved out of conservatorship and privatization can be safely and fairly achieved. By moving away from CRT so swiftly while the GSEs must build capital, the re-proposal unnecessarily risks taxpayer money.

The need for stability created by CRT and consistency in how the FHFA treats CRT is especially significant in the midst of the COVID-19 pandemic and the potential housing crisis that may result. It is likely that the next several quarters will bring increases in defaults and bankruptcies, potentially testing the GSEs' capitalization and forcing draws on their Treasury lines of credit. As of the first quarter of 2020, over 4 trillion dollars in unpaid principal balances of mortgage loans have been partially covered by market-based CRT vehicles offered by the GSEs.[7] For these $4 trillion in guarantees, significant risk of potential losses has been effectively transferred away from the GSEs with little reimbursement risk due to the structure of these vehicles. So far, CRT is properly working to provide certainty to the GSEs and American taxpayers despite our current pandemic-stressed markets.[8]

[7] *See*, Fannie Mae, Data Dynamics (accessed August 14, 2020) and Freddie Mac, CRT Dashboards, Origination Characteristics (accessed August 14, 2020).
[8] Layton, Don, *Demystifying GSE Credit Risk Transfer Part III – Special Interests and Politicization*, Joint Center for Housing Studies of Harvard University (July 2020), Appendix, p. 42.

While it is true that increased regulatory controls and improved market discipline have significantly reduced risks in the housing finance sector, political and economic realities shift rapidly. The FHFA should not assume that the concentration risk posed to the GSEs by virtue of their monoline business is no longer present or being mitigated elsewhere in the housing finance system. Loan level credit enhancements such as private mortgage insurance (PMI) transfers the risk from the GSEs, but ultimately, the risk remains seated in the housing finance sector. In the wake of the 2008 financial crisis, of the seven PMI firms used by Freddie Mac, three failed and three were severely downgraded.[9] For those firms that failed, Freddie Mac received partial or no payment on its claims. PMI may move risk off the books of the GSEs, but ultimately, it retains the risk with institutions with similar mono-lines in the housing finance sector. Another sector-wide stress event like the 2008 financial crisis could render that transfer meaningless and position the GSEs for another bailout.

In comparison, CTR offers diversification of those holding housing finance credit risk across a range of private investors, ensuring the resilience of the American housing finance system. Further, unlike other credit risk transfer vehicles used prior to the 2008 financial crisis, CRT is extremely stable. Because investors deposit the full purchase price upfront, there is little counterparty risk assumed by the GSEs in issuing CRTs.[10] CRTs are a relatively safe, stable vehicle for transferring credit risk out of the GSEs and the housing finance sector as a whole.

CRT is an important tool for protecting taxpayers while allowing for a thoughtful and considered exit from conservatorship for the GSEs. The FHFA should not shift its treatment of CRT in such a drastic manner in the middle of a stress event like the COVID-19 pandemic. Now is when American consumers must be protected, and this sudden change only injects uncertainty into the secondary market. Abruptly moving away from CRT could push more loan volume to other government-backed programs, such as those offered through the Federal Housing Administration, overburdening that agency, concentrating mortgage risk in a few large lenders and continuing to place American tax dollars at risk.

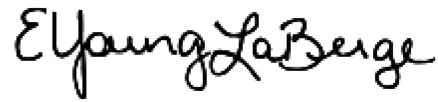
CRT is an efficient mechanism for managing capital and liquidity requirements and by disincentivizing it, the FHFA limits the GSEs' ability to offer a reasonable return on investment and attract potential investors. The re-proposal's treatment of CRT hobbles the GSEs in their effort to raise capital and exit conservatorship. It will likely also result in an increase in g-fees, increasing the cost of mortgage credit and reducing mortgage credit availability to vulnerable borrowers. The FHFA's capital framework should be adjusted before finalization to properly account for its value by providing appropriate reductions in capital for their use, akin to what was provided for in the 2018 proposal.

[9] Layton, Don, *Demystifying GSE Credit Risk Transfer Part II – How, and How Well, Does it Work?*, Joint Center for Housing Studies of Harvard University (February, 2020), p. 24.
[10] Finkelstein, David, Strzodka, Andreas, and Vickery, James, *Credit Risk Transfer and De Facto GSE Reform*, Federal Reserve Bank Of New York Staff Reports, Staff Report No. 838 (February 2018), p. 9.

Conclusion

NAFCU appreciates the opportunity to provide further input on the FHFA's re-proposal of the enterprise regulatory capital framework. NAFCU urges the FHFA to thoroughly consider the impact of over-capitalization on the cost of g-fees and the resulting cost and availability of mortgage loans for the most vulnerable consumers. Further, the FHFA should account for the lower-risk of credit union-originated mortgage loans by discounting the amount of capital which must be reserved against them. Similarly, the FHFA should finalize the rule with CRT-related reductions in capital requirements like that in the prior proposal. If you have any questions or concerns, please do not hesitate to contact me at (703) 842-2272 or elaberge@nafcu.org.

Sincerely,



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