INDEPENDENT COMMUNITY BANKERS of AMERICA®

November 14, 2018

The Honorable Melvin L. Watt
Director
Federal Housing Finance Agency
400 7th St SW
Washington, DC 20219

Re: Enterprise Capital Rules; RIN 2590-AA95

Dear Director Watt:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to provide comments regarding the Federal Housing Finance Agency's (FHFA) proposed regulatory capital framework for Fannie Mae and Freddie Mac (GSEs, Enterprises). We would also like to thank you for your commitment to ensuring the continued stability of the GSEs and championing much-needed administrative reforms. ICBA believes establishing a rigorous capital framework is a necessary precursor to the formal establishment of capital restoration plans by each GSE, both of which are required by Section 1110 of the 2008 Housing and Economic Recovery Act (HERA)[2]. These are critical steps that should culminate in ending the net-worth sweep, rebuilding GSE capital in accordance with the capital framework, and eventually releasing the GSEs from their decade-long conservatorship.

This letter seeks to address several issues related to the proposed capital framework. First, ICBA wants to reiterate how important it is that any capital rule unequivocally address the safety and soundness concerns of the GSEs. In our view, this requires a capital rule that provides similar levels of systemwide and taxpayer protection as other government sponsored institutions such as the Federal Home Loan Banks (FHLBs) and the Farm Credit System (FCS). Instead of focusing on the proper level of capital for a particular FICO/ LTV bucket, we argue that providing an unnecessary capital advantage to the Enterprises could negatively impact the liquidity of the

[1] *The Independent Community Bankers of America® creates and promotes an environment where community banks flourish. With more than 52,000 locations nationwide, community banks constitute 99 percent of all banks, employ more than 760,000 Americans and are the only physical banking presence in one in five U.S. counties. Holding more than $4.9 trillion in assets, $3.9 trillion in deposits, and $3.4 trillion in loans to consumers, small businesses and the agricultural community, community banks channel local deposits into the Main Streets and neighborhoods they serve, spurring job creation, fostering innovation and fueling their customers' dreams in communities throughout America. For more information, visit ICBA's website at www.icba.org.*

[2] Housing and Economic Recovery Act of 2008 §1, 12 U.S.C. §1110 (2008)

secondary market. In other words, the optics of the Enterprises having lower capital requirements than other GSEs and other similarly large financial institutions will result in political distractions and interference, disrupting the market in the process. Furthermore, providing the GSEs with a capital advantage can disadvantage private market participants, including community banks that originate and retain mortgage loans in portfolio. Better alignment of capital requirements for the holding of mortgage credit risk should help level the playing field for all participants, and we urge FHFA to consider that when setting capital standards for the GSEs.

Fannie Mae and Freddie Mac play a critical role in financing homeownership, and community banks depend on them for direct access to the secondary market. The GSEs are friendly aggregators and act as reliable sources of funding for home mortgage lending. They preserve a strong liquid global market for conventional mortgage-backed securities and attract worldwide funding. They are the best and most viable avenues for community banks to originate and sell mortgages, ensuring liquidity even during market downswings. Through them, community banks can retain servicing on the loans they sell, which helps preserve customer relationships. Smaller banks are guaranteed competitive access on a single loan basis through a cash window execution that does not force them to pool and securitize their loans.

Background

Determining GSE capital requirements has long been an important and contentious issue. The Safety and Soundness Act of 1992[3] established the minimum capital required for the GSEs. Minimum capital levels are 2.5 percent of on-balance sheet assets, plus 45 basis points of the unpaid principal of outstanding off-balance mortgage-backed securities (MBS) and an additional 45 basis points for the remaining off-balance sheet obligations. The Act also established the Office of Federal Housing Enterprise Oversight (OFHEO) as the primary safety and soundness regulator for the GSEs but neglected to give OFHEO the authority to raise or lower capital requirements or the authority to resolve a failing or undercapitalized GSE. This made OFHEO an ineffectual regulator and, as a result, the GSEs remained undercapitalized and took on excessive credit risk.

During 2005-2006, the GSEs relaxed their underwriting standards to compete with the private label MBS (PLMBS) markets. Without increasing their capital reserves to absorb the losses to come, they took on more credit risk through the mortgage loans they purchased and securitized, as well as the PLMBS they acquired for their investment portfolios. As a result, the GSEs were blamed for contributing to the Great Recession. Ten years of partisan bickering and the consequent politicization of the GSEs should therefore provide FHFA and all stakeholders the

[3]The Safety and Soundness Act of 1992, 12 U.S.C. §201 (1992)

incentive to consider financial metrics, taxpayer risk, as well as the ***optics*** when establishing a new capital framework.

We strongly agree that a robust capital framework necessitates risk-based capital requirements, rigorous stress testing, and an appropriate minimum leverage capital requirement commensurate with the size and risk of the regulated entities. Safety and soundness are paramount to any workable capital framework plan. As such, we believe that the GSEs should be subject to capital requirements comparable to similarly large global financial institutions whose successes and failures impact the entire housing market and the economy.

When HERA was enacted in 2008 to address the subprime mortgage crisis, it also established the FHFA as the new safety and soundness regulator for both the GSEs and FHLBs. To address the weaknesses of the previous regulatory framework, Congress gave FHFA the authority to manage the risk-based capital requirements for each Enterprise and to take action to force compliance with those requirements. Soon after the enactment of HERA, FHFA used those authorities to place the Enterprises into conservatorship, assuming a dual role as conservator and regulator. Then-Acting FHFA Director Edward DeMarco suspended the statutory capital requirements since the Enterprises were in conservatorship and did not propose new capital requirements (as required by HERA). To provide funding to the GSEs, the U.S. Department of Treasury and the FHFA created the Senior Preferred Stock Purchase Agreements (PSPAs), under which each GSE issued senior preferred stock to the Treasury. These agreements were modified three times between 2008 and 2012. The 2012 amendment that resulted in a net worth sweep of all GSE earnings minus operating expenses made it impossible for them to rebuild their capital.

By 2013, the GSEs became highly profitable, and by 2018 they returned nearly $280 billion dollars back to the Treasury –approximately $100 billion more than they received during the crisis.

The GSEs now support 60 percent of the mortgage market, essentially guaranteeing MBS totaling $5.4 trillion – an amount equaling nearly 20 percent of GDP. In the event of a housing-market downturn, there must be ample protections for the American taxpayer.

Recommendations

In 2017, the proposed capital rule would have required the GSEs to hold at least $180.9 billion in capital, about 3.24 percent of total assets. We recognize that this is substantially larger than the pre-crisis capital requirements, and it is far better than the current 0.1 percent ratio. It is indeed a step in the right direction to insuring safety and soundness. However, ICBA encourages FHFA to go further.

Though we support FHFA's quantitative approach to the proposed capital requirements, we continue to have concerns related to the disparities between the regulatory capital requirements

of the Enterprises and those of similarly large financial institutions and other government-sponsored enterprises. For example, the FHLBs provide wholesale funding for their members' housing-related lending in the form of advances. These advances are basically over-collateralized loans and, like the other GSEs, are backed by an implicit government guarantee. Additionally, FHLB advances are subject to a statutory super-lien. This means that, if an FHLB-member institution becomes insolvent, the FHLB has first rights to the collateral that backed the advances. Since the FHLB system was founded in 1932, FHLBs have not experienced any credit losses. FHLBs' advances and other assets are funded by consolidated debt obligations that are joint and several liabilities, meaning that if an individual FHLB cannot repay it, then the other ten FHLBs are responsible to cover its debt.

The FHLBs, with their strong emphasis on safety and soundness, are required by the Federal Home Loan Bank Act to hold total capital equal to at least 4 percent of total assets, and their leverage capital ratio is set at a minimum of 5 percent, or the sum of permanent capital weighted by a 1.5 multiplier, plus all other capital. The Enterprises, on the other hand, rely on thousands of counterparties, some of which are subject to prudential oversight and some that are not, and the loans they purchase are not overcollateralized. Indeed, this collateral can become impaired and lose value during a downturn. ICBA strongly believes that the GSEs' capital requirements, at a minimum, should be similar to the capital requirements of the FHLBs. That would put the GSEs' total capital at 4 percent with a 5 percent leverage ratio.

We, therefore, suggest that the FHFA implement the proposed framework but with a higher capital requirement that reflects consideration for both protecting the taxpayer and the optics surrounding the GSEs. Furthermore, ICBA recommends that the risk-based capital levels be based on the original loan-to-value (OLTV) of mortgage loans acquired rather than current or marked-to-market LTV. We believe this can be done with minimal disruption to the housing market and would shield the GSEs from criticisms by those who fear a repeat of pre-crisis policies.

FHFA provided extensive commentary in the proposal regarding the difference between the monoline business of the GSEs compared to the myriad business lines of large commercial banks, arguing that the GSEs face different risks and are immune to others that those large banks face. The proposal also discusses the mandate for the GSEs to transfer significant portions of credit risk through the credit risk transfer (CRT) process. All these arguments are focused on justifying a lower capital level for the GSEs relative to other large financial institutions. We concur that the GSEs are not commercial banks and do not face many of the risks that banks do. However, their single line of business also subjects them to risks tied solely to the U.S. housing economy that are without alternative sources of revenue to offset losses when the housing market suffers a downturn. Moreover, the GSEs have an explicit duty to serve all markets, at all times, regardless of economic conditions. Commercial banks can and do contract or exit lines of business during downturns. Finally, while the CRT programs have made great progress, it is still a developing market that has not been tested during times of economic stress. Even FHFA

acknowledges that the CRT market could dry up when the market inevitably experiences a downturn.

The only real answer to any of these issues is for the GSEs to have substantial and meaningful levels of real equity capital and to operate their businesses accordingly.

Conclusion

We believe that implementing a robust capital framework and ending the net worth sweep is a prerequisite for restoring true safety and soundness for the GSEs. FHFA has both the authority and responsibility to direct Fannie Mae and Freddie Mac to advance capital restoration plans and allow them to recapitalize.[4] As such, we urge FHFA and Treasury to end the net worth sweep. We also urge FHFA, as conservator and regulator, to implement this capital framework and require each GSE to submit a capital restoration plan based on this framework, as provided for in HERA.[5]

FHFA, up to this point, has preferred to defer to Congress for any major GSE reform. This has resulted in a conservatorship that has lasted ten years and three Administrations, with no progress on legislative reform. Congress, through HERA, has vested FHFA with significant authority to regulate the GSEs to ensure they operate in a safe and sound condition. No additional authority from Congress is needed to put the GSEs on a path to become fully recapitalized. Furthermore, fully recapitalizing the GSEs does not in any way prevent legislative reforms. Indeed, doing so could make targeted, modest legislative reforms easier to accomplish.

ICBA appreciates the opportunity to provide comments on the proposed capital framework for the GSEs. Community banks continue to depend on the GSEs for direct access to the secondary market, and any disruption to that access is a significant concern for our members. If you have any questions or concerns, please contact the undersigned at ron.haynie@icba.org.

Sincerely,

/s/

Ron Haynie
Senior Vice President, Mortgage Finance Policy

[4] 12 U.S.C. §1143 (2008)
[5] Id.