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Federal Reserve System Board
of Governors
20th St. and Constitution Ave., NW
Washington, DC 20551
Docket No. R-1813
RIN 7100-AG64

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RIN 3064-AF29

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Docket ID OCC-2023-0008
RIN 1557-AE78

Re: Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity

Dear Sir or Madam:

The Housing Policy Council ("HPC")[1] appreciates the opportunity to respond to the Agencies'[2] request for comment on proposed amendments to the regulatory capital requirements for large banking organizations (the "Proposed Rule").[3] HPC members have a direct interest in the Proposed Rule as it relates to the risk weights for residential mortgages, the operational risk calculations that would be applied to mortgages, the securitization of mortgages, the treatment of mortgage insurance, and the servicing of mortgages.

HPC promotes policies that advance a marketplace for residential mortgages that is economically sound, protects and promotes the interests of consumers, and allows private companies to flourish under a set of regulatory rules that are transparent and fair. For example, we supported the establishment of a risk-based capital framework for Fannie Mae and Freddie Mac (the "Enterprises") and capital and liquidity standards for nonbanks that originate and service mortgages.[4] However, for substantive and procedural reasons, we cannot support the Proposed Rule in its current form.

Of note, the treatment of residential mortgage exposures in the Proposed Rule is not aligned with mortgage default risk and does not recognize the reforms in the origination, servicing, and insuring of mortgages that have occurred since the 2008 financial crisis. As a result, the Proposed Rule would produce excessive capital charges for mortgage credit that discourage mortgage lending by large banking organizations and increase the costs of mortgage credit for consumers. This outcome contrasts with the Agencies' own revisions to the regulations implementing the Community Reinvestment Act,

[1] The Housing Policy Council is a trade association comprised of the leading national mortgage lenders and servicers; mortgage, hazard, and title insurers; and technology and data companies. Our interest is in the safety and soundness of the housing finance system, the equitable and consistent regulatory treatment of all market participants, and the promotion of lending practices that create sustainable homeownership opportunities in support of vibrant communities and long-term wealth building for families. For more information, visit www.housingpolicycouncil.org.

[2] We refer to the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Office of the Comptroller of the Currency (the "OCC"), and the Federal Deposit Insurance Corporation (the "FDIC"), collectively, as the "Agencies."

[3] 88 Fed. Reg. 64028 (September 18, 2023).

[4] See letter from Edward J. DeMarco, President, Housing Policy Council to Alfred M. Pollard, General Counsel, Federal Housing Finance Agency on Enterprise Capital Requirements, November 16, 2018; letter from Edward J. DeMarco, President, Housing Policy Council to Alfred M. Pollard, General Counsel, Federal Housing Finance Agency on Enterprise Regulatory Capital Framework, August 31, 2020, letter from Edward J. DeMarco, President, Housing Policy Council to Michael Drayne, Acting Executive Vice President, Ginnie Mae on Eligibility Requirements for Single-Family MBS Issuer, August 9, 2021, and letter from Edward J. DeMarco, President Housing Policy Council to Sandra L. Thompson, Acting Director, Federal Housing Finance Agency on Re-Proposal to Enhance Eligibility Requirements for Enterprise Single-Family Seller/Servicers, April 25, 2022.

which are intended to encourage banks to engage in mortgage lending, and the Financial Stability Oversight Council's commentary on the growth in mortgage origination and servicing by nonbanks.

The Proposed Rule also is procedurally flawed. It does not meet the disclosure standards of the Administrative Procedure Act or the statutory requirement that the Agencies tailor regulations based upon the size of banking organizations.

To address these concerns, we recommend that the Proposed Rule be revised and republished for comment. Specifically, we recommend revisions to the following mortgage-related provisions in the Proposed Rule: (a) the proposed risk weights for residential mortgages; (b) the calculation of the loan-to-value (LTV) ratio used in the establishment of the risk weights; (c) the treatment of second liens; (d) the application of the operational risk charge to mortgages; (e) securitizations; (f) the treatment of mortgage servicing assets (MSAs); (g) the treatment of mortgage insurance; and (h) the treatment of warehouse loans.

Our proposed revisions are based upon a set of general principles that we believe should guide the development and functioning of risk-based capital standards. Observance of these principles would promote an adequate supply of mortgage credit for consumers without creating unacceptable risks for industry participants or the economy.

Section I of this letter sets out those general principles. Section II addresses our procedural concerns with the Proposed Rule. Section III presents our specific recommendations for revising the Proposed Rule.

I. General Principles for Risk-Based Capital Requirements

Capital requirements have a real-world impact for banks and their customers. If properly calibrated, they require more (or less) capital for mortgages that present a greater (or lesser) risk of default. A true risk-based framework should rely on an analytically sound set of risk weights that align capital for a given mortgage to that mortgage's likelihood of default and loss given default. For example, Fannie Mae and Freddie Mac compile data on the millions of mortgages that are delivered into their mortgage-backed securities each year and, as a result, have developed a rich database that reflects mortgage origination and servicing performance across the business cycle. Their regulator, the Federal Housing Finance Agency (FHFA), uses this information to calibrate appropriate risk weights for mortgage exposures.

The proper calibration of capital requirements for mortgage credit is particularly important given the significance of housing to the U.S. economy. Residential real estate represents almost 15 percent of U.S. GDP,[5] and the market for residential mortgages is our nation's largest private debt market, with $13 trillion in debt as of Q3, 2023.[6]

To design capital requirements applicable to mortgages that are appropriately calibrated, HPC believes that the Agencies should observe a set of principles that promote an adequate supply of mortgage credit for consumers without creating unacceptable risks for industry participants or the global economy. Specifically, we believe that the requirements should:

[5] 2022 Annual Report, Financial Stability Oversight Council, p. 19.
[6] Households and Nonprofit Organizations; One-to-Four-Family Residential Mortgages; Liability, Level, 2023: Q3, Federal Reserve Bank of St. Louis.

- Align the capital levels with the risk of residential mortgage exposures and require an amount of capital sufficient to cover unexpected losses on those exposures through the economic cycle;
- Acknowledge the role of banking organizations in the mortgage market as syndicators of risk, not just as the holders of that risk;
- Recognize the regulatory reforms related to mortgage underwriting and servicing that have been put in place since the financial crisis;
- Result in the allocation of mortgage credit based upon risk and not on other ancillary factors;
- Harmonize with other federal regulatory risk-based capital frameworks to avoid regulatory arbitrage; and
- Encourage structures that spread mortgage credit risk to various intermediaries across nation's financial system.

Capital requirements grounded in these principles would be rigorous, yet balanced, permitting an adequate supply of mortgage credit without creating unacceptable risk. Further, with well-calibrated rules, banking organizations can tailor their risk management practices and controls to minimize and mitigate the risk of mortgage credit rather than exit from this important segment of consumer lending. In Section III, we recommend several revisions to the Proposed Rule to conform the treatment of mortgage credit with these principles.

II. Procedural Issues with the Proposed Rule

The Proposed Rule does not meet the standards for transparency required by the Administrative Procedure Act.

The Administrative Procedure Act (the "APA") requires that a notice of proposed rulemaking include either the terms or substance of the proposed rule or a description of the subjects and issues involved and give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments.[7] These requirements have been interpreted by federal courts to impose an obligation on an agency "to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules."[8] The Agencies have not satisfied this obligation in the Proposed Rule.

The Proposed Rule does not include data or analysis to support key provisions that affect mortgage credit. For example:

- The Proposed Rule justifies the risk weights for mortgages based upon competitive concerns rather than any analysis of the risk of mortgage credit or the impact of the proposed risk weights for mortgages on the mortgage market;
- The Proposed Rule addresses the capital treatment of 1st and 2nd liens in a footnote and does not otherwise explain the rationale for the proposed mortgage-related risk weights for banks that hold both a 1st and 2nd lien;

[7] 5 U.S.C. §§ 553(b)(3) and (c).
[8] *Owner-Operator Independent Drivers Association v. FMCSA*, 494 F.3d 188, 199 (D.C. Cir. 2007).

- The Proposed Rule does not address or justify the impact of the application of the operational risk charge on mortgage loans;
- The Proposed Rule reverses, without explanation, a 2019 determination by the Agencies on the regulatory capital treatment of mortgage servicing assets; and
- The Proposed Rule adopts a position on mortgage insurance that fails to recognize the changes in industry practices and oversight that have occurred since the 2008 financial crisis.

The lack of data and analysis in the Proposed Rule deprives HPC and its member companies the information necessary to evaluate the Agencies' basis for these provisions in the Proposed Rule and, therefore, violates the requirements of the APA.

Additionally, the Agencies' rationale for the proposed risk weights on residential mortgage loans is arbitrary and capricious under applicable interpretations of the APA by the U.S. Supreme Court. The U.S. Supreme Court has stated that an agency decision is arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider.[9] In the preamble to the Proposed Rule, the Agencies acknowledge that the risk weights for residential mortgages are based upon an attempt to mitigate potential competitive effects of the capital requirements.[10] Yet, the purpose of regulatory capital is to enhance safety and soundness, not to provide a competitive advantage to one group of banks over another.[11]

In an apparent effort to address these concerns, the Federal Reserve Board has launched a data collection to gather more information from banking organizations affected by the Proposed Rule. While this is a welcome development, the information gathered from that exercise and the Agencies' analysis of that information must be made available for public comment in order for the Proposed Rule to comply with the APA. The additional information will obligate the Agencies to republish the Proposed Rule, and in doing so, we urge that the Agencies incorporate the recommendations described below.

The Proposed Rule does not meet the statutory directive for tailoring regulations based upon size.

In the Economic Growth, Regulatory Relief, and Consumer Protection Act, Congress directed that the prudential standards applicable to banking organizations, including capital requirements, differentiate between banking organizations based upon asset size.[12] The Proposed Rule does not meet this requirement. The Proposed Rule treats all banks with $100 billion or more in assets similarly, even though regional banks and money center banks are not the same. The proposed operational risk charge for all banks with $100 billion or more in assets illustrates the problems with this approach. While banking organizations with higher overall business volume would correlate with higher operational risk capital requirements under the Proposed Rule, the operational risks faced by a banking organization with $100 billion in assets are clearly lower than those faced by a banking organization with $2 trillion in assets.

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[9] *Motor Vehicle Manufacturers Association v. State Farm Auto Mutual Insurance Co.*, 463 U.S. 29 (1983)

[10] 88 Fed. Reg. 64170 (September 18, 2023) ("the proposal attempts to mitigate potential competitive effects between U.S. banking organizations by adjusting the U.S. implementation of the Basel III reforms, *specifically by raising the risk weights for residential real estate* and retail credit exposures." Emphasis added).

[11] See, for example, the Comptrollers Handbook, Safety and Soundness, Capital and Dividends, Version 1.0, July 2018, ("... [regulatory capital] requirements generally serve as a restraint on excessive risk-taking and expansion activities, promote safety and soundness in the banking system, and protect the Deposit Insurance Fund.") p. 2.

[12] Title IV of P.L. 115-174.

III. Mortgage Concerns and Recommendations

A. The Risk Weights for Residential Mortgage Exposures

To improve the accuracy of the risk weight applicable to mortgage exposures, the 2017 Basel Accord proposed that the risk weights for residential mortgages be tied to LTV ratio of a mortgage loan and the occupancy of the property.[13] While the Proposed Rule incorporates these refinements, it distorts the original intent by increasing the risk weights for residential mortgages proposed in the Basel Accord, adding 20 percentage points in every LTV category. For example, under the Basel Accord, a mortgage on an owner-occupied property with an LTV of between 80-90 percent would be subject to a 40 percent risk weight, whereas under the Proposed Rule the risk weight would be 60 percent.

This proposed divergence from the treatment of mortgage credit under the Basel Accord raises several concerns. It is based upon factors other than risk. It fails to recognize the regulatory reforms related to mortgage underwriting and servicing that have been put in place since the 2008 financial crisis. And it is inconsistent with the data-driven regulatory capital framework established by FHFA for the Enterprises.

The Proposed Rule should establish capital standards based on risk.

The Proposed Rule is intended to "strengthen the calculation of risk-based capital requirements to better reflect the risks of these banking organizations' exposures."[14] Indeed, the consideration of the LTV ratio for a mortgage loan and the occupancy status of the property is more risk sensitive than the current standardized approach that applies a 50 percent risk weight to all prudently underwritten mortgages. However, the add-on to the Basel Accord risk weights for residential mortgages is not based on risk; the higher standard is based upon concerns about potential competition between large and small banks.

In the preamble to the Proposed Rule, the Agencies state that "the proposal attempts to mitigate potential competitive effects between U.S. banking organizations by adjusting the U.S. implementation of the Basel III reforms, *specifically by raising the risk weights for residential real estate* and retail credit exposures."[15] This Agencies' rationale is fundamentally flawed. It does not address the reality that large banks are subject to additional capital requirements that do not apply to smaller banks. For example, large banks are also subject to the stress capital buffer requirement and, under the Proposed Rule, would be subject to standardized operational risk capital requirements. Large banks are further subject to other prudential requirements not applicable to smaller banks, including those related to total loss-absorbing capacity, the liquidity coverage ratio, and the net stable funding ratio.

The Agencies' concern about competition between large and small banks should not be addressed through regulatory capital standards. The purpose of a risk-based capital regulation is to tie the capital requirement for a given asset – in this case a residential mortgage – to the asset's estimated credit risk. Naturally, the more precise the assessment, the greater the regulation's complexity. The current Standardized Approach gives smaller banks the benefit of simplicity – a single risk weight for all mortgages, whether the borrower has a 10 percent down payment or a 50 percent down payment. Yet, with the addition of the higher risk weights in the Proposed Rule, the Agencies effectively acknowledge that the risk weights in the Standardized Approach are not properly aligned with the risk of mortgage defaults. The Bank Policy Institute has stated that over the past ten years the average risk weight for

[13] Under the Basel Accord, higher risk weights would apply to investment properties.
[14] 88 Fed. Reg. 64030 (September 18, 2023).
[15] 88 Fed. Reg. 64170 (September 18, 2023), emphasis added.

mortgage loans based upon loss experiences has been just 24 percent.[16] A study by the Urban Institute also found that the presumed loss rates used in the Proposed Rule exceed the loss rates experienced during the 2008 financial crisis.[17]

While the Agencies invite public comment on retaining the risk weight of 50 percent for prudently underwritten loans originated through programs designed to support low- and moderate-income home buyers or other historically underserved markets,[18] such an exception would contribute to further market distortion, setting the capital levels on factors other than risk. This subverts the purpose of such requirements. The better answer is to apply the risk weights proposed in the Basel Accord to all mortgages, regardless of the size of the bank (or at least let smaller institutions choose the simplicity of the standardized 50% risk weight over a true risk-based approach, should they prefer to avoid operational changes needed to adopt the Basel standard.)

Regulatory reforms put in place since the financial crisis have reduced mortgage credit risk across the marketplace.

The higher risk weights for residential mortgages in the Proposed Rule are not only excessive, they also are at odds with the reforms that Congress and federal financial regulators put in place to reduce mortgage risk after the 2008 financial crisis. Those reforms, which prohibit unsafe loan features and require lenders to verify a borrower's ability to repay a loan, have materially reduced the risk of mortgage loans.

The Financial Stability Oversight Council ("FSOC") 2022 Annual Report states that "mortgage underwriting standards remain high, with the median credit score of newly originated mortgages standing at 773 in Q2 2022, an increase from below 750 in the years before the 2008 financial crisis."[19] FSOC's 2023 annual report also notes that "[mortgage] credit performance remains strong, owing to a tight labor market and considerable levels of home equity. For example, 89% of all outstanding loans have mark-to-market LTV of 80 % or less."[20] The Agencies should consider this government-compiled market data when setting the risk weights for mortgage credit.

The Proposed Rule is not consistent with the regulatory capital framework established by the FHFA for the Enterprises.

In 2020, FHFA finalized a regulatory capital framework for the Enterprises.[21] This Enterprise Regulatory Capital Framework (ERCF) is designed to establish Enterprise capital levels that would be sufficient for the companies to be regarded as a viable going concern by creditors and counterparties both during and after a severe economic downturn comparable to the 2008 financial crisis. The ERCF applies a more granular assessment of the risk of mortgage exposures than the Proposed Rule, with factors that include: LTV ratios, credit scores, debt-to-income ratios, owner-occupancy, the dependency on rental income, and the impact of credit risk mitigants such as mortgage insurance and credit risk transfers. FHFA calculated that, as of 2020, the average risk-weight for a single-family mortgage under the ERCF was 43 percent before credit enhancement (mortgage insurance), 37 percent before credit risk transfer, and 31 percent after credit risk transfer.

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[16] Testimony of Greg Baer, President and CEO, Bank Policy Institute, before the U.S. House Financial Services Committee's Subcommittee on Financial Institutions and Monetary Policy, September 14, 2023, p. 16.
[17] Laurie Goodman and Jun Zhu, *Bank Capital Notice of Proposed Rulemaking: A Look at the Provisions Affecting Mortgage Loans in Bank Portfolios*, Urban Institute, September 2023.
[18] 88 Fed. Reg. 64048 (September 18, 2023).
[19] Financial Stability Oversight Council, 2022 Annual Report, p. 19.
[20] Financial Stability Oversight Council, 2023 Annual Report, p. 24.
[21] 85 Fed. Reg. 82150 (December 17, 2020).

During the development of the ERCF, FSOC (whose membership includes the Agencies) explicitly acknowledged that the risk-weights for mortgages under the ERCF would be lower than the risk weights for mortgages held by banks.[22] To address the discrepancy, FSOC encouraged FHFA and the Agencies "to coordinate and take other appropriate action to avoid market distortions that could increase risks to financial stability by generally taking consistent approaches to the capital requirements and other regulation of similar risks across market participants, consistent with the business models and missions of their regulated entities."[23] Similarly, in its 2022 annual report, FSOC recommended that its member agencies "leverage existing authority to ensure that the same activity with the same risk, when conducted by different entities, has the same regulatory outcome."[24]

If the Agencies have made any attempt to reconcile the differences in the Proposed Rule with the ERCF, per the FSOC recommendation, it is not apparent. The preamble to the Proposed Rule makes no reference to the ERCF, even though the ERCF was developed by the one federal regulatory agency principally charged with the regulation and supervision of the market for mortgage credit.

The divergent treatment under the Proposed Rule and the ERCF likely will further the market dominance of the Enterprises and the nonbank share of mortgage originations. Prime mortgage loans financed by banks will face significantly higher capital charges for credit risk than the Enterprises incur. The ability of banks to price for the added capital is severely limited and is nonexistent for most mortgages, given the Enterprises' liberal conforming loan limit. That limit – more than $1 million in higher cost areas and more than $766,550[25] in the rest of the country – means those loans can be financed through the already subsidized Enterprises, which can hold those same loans with significantly less capital than banks subject to the Proposed Rule.

This type of regulatory capital arbitrage contributed directly to the 2008 financial crisis. In the financial crisis, it was the Enterprises whose capital requirements were untethered from actual risk, reflected in excessively low capital requirements. With the ERCF, FHFA has created a well-calibrated risk-based framework for mortgages that draws directly from the current banking framework. By ignoring this important work, the Proposed Rule would result in excessively high bank capital requirements relative to actual risk, again opening a capital arbitrage across the prudential federal regulatory regimes governing residential mortgage lending. This will shift mortgage lending activity away from banks and towards nonbanks and the Enterprises which further exacerbates a distortionary trend that FSOC has identified in the last several annual reports.

Table 1, below, summarizes the risk weights for mortgage loans on owner-occupied residences under: (1) the current Standardized Approach, which would continue to apply to banking organizations with less than $100 billion in assets; (2) the 2017 Basel Accord; (3) the Expanded Approach in the Proposed Rule; (4) the Expanded Approach inclusive of the operational risk charge in the Proposed Rule (the "Effective Risk Weight"); and (5) the ERCF.

[22] Financial Stability Council Statement on Activities-Based Review of Secondary Mortgage Market Activities, p. 2 September 25, 2020. ("The Enterprises' credit risk requirements, however, likely would be lower than other credit providers across significant portions of the risk spectrum and during much of the credit cycle, which would create an advantage that could maintain significant concentration of risk with the Enterprises.").

[23] Id.

[24] 2022 Annual Report, Financial Stability Oversight Council, p. 65.

[25] 2024 Conforming Loan Limit Values, Federal Housing Finance Agency, November 28, 2023.

The Table shows that the risk weights for residential mortgages under the Proposed Rule are higher than the risk weights under the current Standardized Approach, the 2017 Basel Accord, and the ERCF in all but the very lowest LTV categories. This excessive capital charge inevitably will result in reduced mortgage lending by large banking organizations and/or increased fees to consumers, especially those in the higher LTV categories. Neither result is justifiable based on the default risk of mortgages subject to the post-2008 regulatory reforms.

Table 1
Risk Weights for Mortgage Loans on Owner-Occupied Properties
Held in Portfolio

	LTV ≤ 50%	LTV 50 -60%	LTV 60-80%	LTV 80-90%	LTV 90-100%	LTV > 100%
Current Standardized Approach	50%	50%	50%	50%	50%*	50%*
2017 Basel Accord	20%	25%	30%	40%	50%	70%***
Expanded Approach in the Proposed Rule	40%	45%	50%	60%	70%	90%
Expanded Approach including op risk charge (the Effective Risk Weight)**	43-46%	48-51%	53-56%	63-66%	73-76%	93-96%
Enterprise Regulatory Capital Framework	2-6%	13.7%	18-33%	28-34%*	20-28%*	N.A.

*With mortgage insurance (MI).
**It has been estimated that the operational risk charge would add 3-6 percentage points to the risk weight on mortgages.[26]
*** 50% with MI

Recommendation – Alternative 1: Adopt the risk weights for residential mortgages proposed in the Basel Accord and extend them to all banks.

To better align the risk weights with the actual risk of mortgage exposures, we recommend that the Agencies conform the U.S. risk weights with the 2017 Basel Accord. This revision alone would give the U.S. capital treatment consistency with international banks. More importantly, this change would be a more accurate reflection of risk of mortgage exposures. Given the more risk sensitive approach in the 2017 Basel Accord, we also recommend that the Agencies offer banks with under $100 Billion in assets the choice of using the Basel Accord's LTV based risk-based risk weights or the current use of the Standardized Approach.[26]As discussed further below, we also recommend that the Agencies retain the current treatment of mortgage insurance for prudently underwritten mortgages.

[26] Extending the Basel Accord's risk weights for mortgage exposures to banking organizations with less than $100 billion in assets may require other adjustments to the capital standards for those banks to permit compliance with the so-called Collins Amendment to the Dodd-Frank Act. The Collins Amendment, which appears in section 171 of the Dodd-Frank Act, requires the federal banking agencies to establish minimum risk-based and leverage capital requirements for banking organizations that are no less than, nor quantitatively lower than, the generally applicable capital requirements that were in effect for insured depository institutions on the date of enactment of the Dodd-Frank Act.

Recommendation – Alternative 2: Coordinate the treatment of bank capital with the ERCF.

More fundamentally, we urge the Agencies to accept the recommendation of FSOC and coordinate the treatment of bank capital with the ERCF. The risk weights embedded in the ECRF are based upon an extensive review of mortgage credit risk that took into consideration factors beyond just LTV ratios. The ERCF also has the benefit of extensive, loan-level modeling by FHFA, which appears absent in the Agencies' proposal. We recognize, as does FHFA, that the relative risks of banks and the Enterprises are not the same.[27] Nonetheless, since bank portfolios are the logical alternative to secondary market sales to the Enterprises, and since prime bank portfolio loans generally perform better than Enterprise loans, the ERCF could be seen as a conservative alternative to the Proposed Rule. To be clear, we are not recommending that the Agencies simply adopt the ERCF. We do believe, however, that mortgage credit should be treated the same regardless of how it is originated and serviced. Given the tremendous volume of mortgage data held by that FHFA and the Agencies, a cooperative approach to establishing capital charges for mortgage credit should be possible.

B. Calculating the LTV Ratio

In calculating the LTV ratios that are tied to the risk weights for mortgages, the Proposed Rule uses LTV ratios as of the origination date for the mortgage, unless certain exceptions apply, such as a decrease in the value based upon a disaster or an increase in the value based upon home improvements. Otherwise, the value of the property at origination would remain fixed for purposes of the denominator in the LTV calculation. The numerator in the calculation, the loan amount, would decline as a loan amortizes, and over time this would move the loan into a lower risk weight category.

In comparison, the ERCF adjusts the LTV every six months based upon the market value of the property (a mark-to-market LTV or MTMLTV), subject to a countercyclical adjustment. FHFA concluded that mark-to-market LTVs more accurately represent the Enterprises' current risk profile than original LTVs because the current value of a house influences both the probability that a homeowner will default on the mortgage and the magnitude of losses if a homeowner defaults.[28] FHFA recognized, however, that, as originally proposed, the ERCF could have a pro-cyclical impact on housing credit, that is capital requirements would increase in periods of market stress. To partially offset this impact, FHFA incorporated a countercyclical adjustment in the calculation of MTMLTVs when national housing prices are 5.0 percent above or below the inflation-adjusted long-term trend.

Recommendation: Adjust the LTV based upon market value after 5 years.

HPC generally supported FHFA's proposal for using MTMLTVs. However, in order to mitigate the procyclical impact of MTMLTVs, we proposed to FHFA that mark-to-market adjustments begin at 60 months after origination. We recommend that the Agencies adopt this approach. At the margin, this would free up more bank and Enterprise capital after a five-year mortgage seasoning period. Moreover, adjusting LTVs based solely on loan amortization, as the Agencies propose, would exacerbate the capital arbitrage between the Enterprises and banks and, over time, would further exacerbate the negative effect on mortgage credit due to the excess capital requirement imposed at origination under the Proposed Rule.

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[27] 83 Fed. Reg. 33332 (July 17, 2018) ("These differences include, among others, the sources and associated risk level of income and assets, differences in funding risk, and the relative exposure to mortgage assets.")
[28] 83 Fed. Reg. 33332 (July 17, 2018).

C. Second Liens

The Proposed Rule treats first liens inconsistently based on who holds the second lien.

Under the current Standardized Approach, a bank that holds both a 1st and 2nd lien on the same property (with no intervening liens) must combine the exposures and treat them as a single first-lien residential mortgage exposure. If the first lien is prudently underwritten, this treatment permits a bank to apply a 50 percent risk weight to the combined exposures.

The Proposed Rule would adopt the same treatment for 1st lien and 2nd liens by the same bank on the same property (with no intervening liens).[29] However, because the risk weights for residential mortgages under the Proposed Rule are higher for loans in higher LTV categories, the Proposed Rule frequently will result in an increase in the risk weight on the 1st lien exposure if the same bank holds the 2nd lien exposure.

The Agencies do not explain why a bank that is subject to the Proposed Rule and that holds both liens should have a higher capital requirement than a bank that remains subject to the Standardized Approach. Likewise, the Agencies do not explain why the capital treatment for 1st and 2nd lien residential real estate exposures on the same property applies only if the bank holds both liens. Moreover, the Proposed Rule fails to recognize the risk management benefits when a bank holds both the 1st and 2nd lien exposures on the same property. In those cases, a bank is better positioned to coordinate the handling of both liens should the borrower run into financial hardship.

Recommendation: We recommend separate risk weights for 1st and 2nd liens.

We recognize that the higher cumulative LTV resulting from the 2nd lien may warrant a higher risk weight on the 2nd lien (regardless of which bank holds the 2nd lien) relative to the 1st lien exposure. However, the 1st lien exposure held by the same bank should not receive a higher risk weight than it would receive if it were held by a different bank. Accordingly, we recommend that the treatment of the 2nd liens in the Proposed Rule be modified to separate the risk weights for 1st and 2nd liens.

D. Operational Risk

The operational risk charge is flawed fundamentally and should be dropped or completely re-thought.

The proposal would implement a new capital charge for operational risk based on the Basel framework. The Agencies define operational risk to be the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events, including legal risk but excluding strategic and reputational risk. Examples of such operational risks include the costs associated with fraud, lawsuits, fines, and systems interruptions.

Currently, only the very largest banking organizations are subject to a capital charge for operational risk, and that charge is calculated based upon the bank's own internal models. In the preamble to the Proposed Rule, the Agencies note that the current treatment of operational risk "can present substantial uncertainty and volatility, which introduces challenges to capital planning processes ... has resulted in a lack of transparency and comparability across banking organizations [and

[29] 88 Fed. Reg. at 64045 (September 18, 2023), n. 81.

as a result] supervisors and market participants experience challenges in assessing the relative magnitude of operational risk across banking organizations, evaluating the adequacy of operational risk capital, and determining the effectiveness of operational risk management practices."[30]

To address these concerns, the Proposed Rule would replace the current model-based approach with a new standardized approach and apply it to all banking organizations with $100 billion or more in assets. The capital requirements under this standardized approach for operational risk would be a function of a banking organization's business indicator (BI) component and internal loss multiplier (ILM). The BI is a proxy for a banking organization's business volume. It is based upon the three-year rolling average of income derived from: (a) lending and investment activities (i.e., interest, lease, and dividend income); (b) fee and commission-based activities (i.e., services income); and (c) trading activities. Income from lending and investment activities would be subject to a cap equal to 2.25 percent of the bank's interest income-generating assets. There is no similar cap for income derived from services – the services component.

The ILM is based upon the banking organization's actual historical operational loss experience but the proposed rule imposes a floor, thereby limiting the benefit of a strong operational loss record. The Agencies note that under this new standardized approach "Banking organizations with higher overall business volume are larger and more complex, which likely results in exposure to higher operational risk."[31]

We have several concerns with the calculation of the operational risk capital charge in the Proposed Rule. First, it is a non-risk sensitive measure that effectively is a tax on a bank's income. It penalizes diversity of income sources, especially fee businesses since there is no cap on fee income for purposes of the calculation as there is for interest income. It also duplicates reserves banking organizations have otherwise established for litigation and fraud losses.

Second, the operational risk charge will create significant return-on-equity volatility for a bank's mortgage business. Under the Proposed Rule, the services component of the BI calculation is a three-year average of fees generated. This three-year look back will result in excess capital during periods of lower mortgage originations that follow periods of high originations, much like the industry is currently experiencing. Conversely, in years of high origination following a down cycle, the charge will be low relative to current business volume.

Third, this approach results in the double counting of operational risk for those banks subject to the stress capital buffer that includes operational risk losses. In addition, MSAs, are either deducted from regulatory capital or subject to a 250 percent risk weight that incorporates operational risk.[32] The Proposed Rule provides no explanation for inclusion of MSAs in the BI calculation, nor justification for the imposition of two types of operational risk weights.[33]

[30] 88 Fed. Reg. 64082 (September 18, 2023).
[31] 88 Fed. Reg. at 64083 (September 18, 2023).
[32] In 2019, the Agencies issued a regulation revising the capital treatment of MSAs for non-advanced approaches banking organizations. In the preamble to that regulation, the Agencies acknowledged that the revised capital treatment for MSAs was based, in part, on business risks: "The [Report to the Congress on The Effect of Capital Rules on Mortgage Servicing Assets] noted that the profitability of banking organizations can be affected by holdings of MSAs because of the *business risk related to litigation and compliance costs* associated with mortgage servicing. The final rule's revised treatment for MSAs should continue to protect banking organizations from the uncertainty arising from the liquidity risk, valuation risk, and business risks described above." (emphasis added). 84 Fed. Reg. 35238 (July 22, 2019)."
[33] Applying the Agencies proposed operational risk calculation to the incomes generated from MSAs and mortgage-backed warehouse lines would in fact result in significantly lower risk weights than the current 250 percent and 100 percent currently imposed. Neither approach uses an analytical basis to assess risk – they essentially are just add-ons to cover a regulatory concern that is neither well-formulated nor grounded in empirical evidence.

Fourth, the operational risk charge fails to acknowledge the role of banking organizations as syndicators of mortgage risk, not only the holders of that risk. Most bank mortgage lending is done by banks that originate loans for subsequent sale into the secondary market.[34] Selling a loan after origination (the "originate-to-distribute" model of business) enables a bank to replenish capital to make additional mortgage loans. The operational risk charge in the Proposed Rule will increase the cost of this business model. Under the operational risk charge, a bank that sells a mortgage loan will face a capital charge for interest income while it holds the loan and a capital charge for the fees it earns from the sale. The Bank Policy Institute estimates that these additional charges could double the total amount of required capital.[35] These additional capital charges on the originate-to-distribute model are not explained or justified in the Proposed Rule and will reduce the volume of mortgage loans originated by large banking organizations.

Finally, on a more fundamental level, capital should be designed to absorb unexpected losses when they occur. However, the proposed operational risk capital charge is simply a tax on income. It is not predicated on any analytical or historical measurement of operational losses, either regarding the source or magnitude of such losses. A cyber-attack or a loss due to a natural disaster is not a function of the amount of income generated by mortgages sold to Ginnie Mae or the Enterprises. Indeed, the entire premise of an income-based estimate of operational risk distorts bank business decisions and penalizes non-interest earning sources of income. Operational risk should be left to supervisory review or, at best, be a small add-on to banks' overall capital requirements.

Recommendation: Eliminate or replace the proposed operational risk framework

HPC's recommends that the Agencies delete, or alternatively overhaul, the proposed operational risk framework.

Short of eliminating or overhauling the proposed approach, at a minimum the Agencies should consider the following changes to mitigate some of the distortions created by the proposed approach:

- Eliminate operational losses from the stress capital buffer;
- Remove the ILM floor of one, and either set the ILM to one or allow it to fluctuate symmetrically;
- Recalibrate the Business Indicator coefficients to a flat 12%;
- Risk weight different business lines within the services component[36] and allow netting of fee and expenses or place a cap on the services component of the BI calculation similar to the cap on the interest component; and
- Eliminate MSA income from the BI and operational risk weight calculations.

E. Securitizations

The approach to securitizations in the proposed rule fails to recognize recent reforms.

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[34] Greg Buchak, Gregor Matvos, Tomasz Piskorski, and Amit Seru, *Aggregate Lending and Modern Financial Intermediation: Why Bank Balance Sheet Models are Miscalibrated*, May 30, 2023, page 10 (While approximately one-half of all banking organizations continue to hold mortgages on balance sheet, those mortgages represent only 4 percent of total bank mortgage originations.)

[35] Paul Calem and Francisco Covas, *The Basel Proposal: What it Means for Mortgage Lending*, Bank Policy Institute, p. 10.

[36] In addition, the operational risk charge for mortgages can be misaligned because of the cyclicality of mortgage originations. The Agencies should also consider adjusting the 3-year look-back of the BI calculation for mortgages by dividing the average assets during that period and applying the BI to the current year's average asset base.

The Proposed Rule would create a new securitization standardized approach (the "SEC–SA") to replace the supervisory formula approach and standardized supervisory formula approach (the "SSFA"). Under the proposed SEC-SA model, the supervisory calibration parameter, p, (the "p-factor") would increase from 0.5 to 1.0. The p-factor is a securitization capital surcharge. In the preamble to the Proposed Rule, the Agencies explain that the proposed doubling of the p-factor "would help to ensure that the framework produces appropriately conservative risk-based capital requirements when combined with the reduced risk weights applicable to certain other assets under the proposal."[37] Yet, the Agencies do not provide any data or analysis to support this determination.

The Agencies incorporated SSFA into the capital rule in 2013. Since that time, the regulatory environment in which securitization operates in the United States has changed considerably. Most notably, the requirements of Regulation RR[38] (credit risk retention) became applicable on December 24, 2015, for all asset-backed securities backed by residential mortgages, and on December 24, 2016, for all other classes of asset-backed securities. As the Agencies and the other regulators observed when they adopted Regulation RR, that rule was a significant, but not the only, part of a much larger legislative and regulatory effort to improve securitization and lessen its risks.

Recommendation: Apply a lower p-factor to "qualifying securitization transactions."

Given the foregoing developments, we support an alternative approach to addressing securitizations proposed by the Structured Finance Association in their comment letter. That approach calls for the recognition of a new category of securitization transactions called "qualifying securitization transactions" or "QSTs." QSTs would be assigned a p-factor of 0.25, and securitizations that are non-QSTs would be assigned a p-factor of 0.5. For a securitization transaction to qualify as a QST:

- The securitization cashflow waterfall must be sequential, with senior liabilities receiving priority payment either from inception, in the case of amortizing structures, or following the occurrence of an early amortization event, in the case of revolving structures.
- The underlying exposures must be of the same type. For example, all the underlying assets in an auto securitization must be auto loans and/or leases and related property. Underlying exposures consisting of equipment loans, floorplan loans, etc., may not be mixed into the pool.
- A minimum of 5 years of historical performance data for receivables with substantially similar risk characteristics to those being securitized must be evaluated by the bank.
- Both the originator and servicer of the receivables must have a minimum of 5 years' experience as originator or servicer, respectively.
- At the time of the final cut-off date of the securitized portfolio, no receivables are greater than 30 days past due and no receivables are in default.
- The performance of the underlying exposures is provided in the monthly report required by the transaction documents.
- For securitizations featuring a revolving period, the transaction documents must contain provisions for appropriate early amortization events and/or triggers terminating the revolving period.

[37] 88 Fed. Reg. 64070 (September 18, 2023).
[38] 12 C.F.R. § 244.

- For traditional securitizations, a true sale and non-consolidation opinion must be obtained or an FDIC safe harbor opinion, as applicable. For synthetic securitizations, an enforceability opinion must be obtained.

This proposed QST approach would better align the U.S. securitization framework with the framework applied in the EU. More importantly, the QST approach would help to better calibrate the SEC-SA model by adjusting it to reflect important risk measures that are not captured by its inputs. Furthermore, the vast majority of Private Label Mortgage-Backed Securities would qualify as QSTs.

In the alternative, if the Agencies choose not to adopt the proposed QST framework, we recommend that Credit Risk Transfers that are Regulation Q eligible should be afforded a 0.5 p-factor.

F. Mortgage Servicing Assets

The capital charge for MSAs is excessive.

The current risk-based capital regulations treat mortgage servicing assets differently based upon the size of a banking organization. Banking organizations with $700 billion or more in assets (Category I and II banking organizations) must deduct from common equity tier 1 (CET1) capital the amount of MSAs that exceed 10 percent of the organization's CET1 capital. In addition, the aggregated amount of the banking organization's MSAs, deferred tax assets (DTAs), and significant investments in unconsolidated financial institutions (UFIs) that exceed 15 percent of CET1 must be deducted, and any MSAs not deducted are assigned a 250 percent risk weight.

In contrast, banking organizations with between $100 billion and $700 billion in assets (Category III and IV banking organizations) are subject to a higher deduction threshold (25 percent) and are not subject to an aggregate limit on MSA's, DTAs, and investments in UFIs. Like the Category I and I banking organizations, MSAs not deducted from CET1 by Category III and IV banks are assigned a 250 percent risk weight.

The Proposed Rule would extend the more stringent treatment of MSAs currently applicable to Category I and II banking organizations to Category III and IV banking organizations. This proposal will further reduce the bank engagement in mortgage servicing and does not reflect the risk of holding these assets.

In its recent annual reports, FSOC has expressed some concern over the growth in mortgage servicing by nonbanks.[39] This trend has been driven, in large part, by the bank capital treatment of MSAs. Extending the more stringent capital treatment for MSAs to all banks with $100 billion or more in assets will exacerbate this trend; additional bank withdrawal will further reduce the liquidity for MSAs, removing a group of significant market participants that have the capital, liquidity, and sophistication to manage this asset in support of borrowers.

Both the current and proposed capital treatment of MSAs ignore the natural hedge that mortgage servicing provides to financing mortgages. Indeed, we have seen that value just in the past two years. As interest rates rose, the value of long-term fixed-rate mortgages declined but the value of servicing those mortgages rose. Likewise, when interest rates decline, mortgage servicing values decline but the value of financed mortgages increase. Furthermore, declining rates generate greater mortgage

[39] 2023 Annual Report, Financial Stability Oversight Council, p. 24 ("Nonbanks service over half of all mortgages, with a servicing share of 54 percent as of the second quarter of 2023, compared with 20 percent in 2013.")

volume through refinance activity and new mortgage activity from home sales. In that environment, older, lower value MSA assets frequently are replaced by new, higher value MSAs. It remains a mystery to the housing finance industry why bank capital requirements treat MSAs as riskier than most other commercial assets, when it represents servicing loans for home ownership and it has certain attractive risk-management properties. For example, the fee income and float derived from mortgage servicing is a valuable non-interest margin income stream. Yet, as described earlier, the operational risk component of the proposed rule penalizes banks for this fee income.

The treatment of MSAs in the Proposed Rule also ignores banking practices designed to address the volatility of MSAs, such as hedging and mark-to-market practices.

Additionally, the proposed extension of the more stringent capital treatment for MSAs to all banks with $100 billion or more in assets conflicts with prior determinations by the Agencies related to the risk of MSAs. In 2019, following a periodic review of the costs and burdens of regulations, the Agencies found that the 10 percent individual threshold for MSAs and a 15 percent aggregate threshold deduction for MSAs, DTAS, and investments in UFIs were unnecessarily complex and burdensome.[40] In response, the Agencies decided to adopt the less stringent 25 percent threshold to Category III and IV banking organizations. At that time, the Agencies stated that the 25 percent CET1 deduction threshold was sufficient to "appropriately" balance risk-sensitivity and complexity for those banking organizations.[41]

Finally, there is the risk of increased volatility in the value of MSAs in the marketplace by banks placing assets they can no longer hold. The results could include a decline in the value of the assets necessitating holders to write down the value of the MSAs on their books, increase borrowers' interest rates to make up for the decline in value and drain liquidity out of the market.

In the Proposed Rule, the Agencies do not provide any substantive explanation for the reversal of this finding. The sole explanation for the change is the self-evident statement that extending the more stringent capital treatment to Category III and IV firms will "creat[e] alignment across all banking organizations subject to the proposal."[42] If alignment is the goal, the simple solution should be to treat Category I and II banks the same as Category III and IV are treated today.

Recommendation: Revise the treatment of MSAs.

We recommend that the Agencies take one of the following alternative approaches to the treatment of MSAs held by Category III and IV banking organizations:

- First, continue to apply the existing simplified 25 percent deduction framework to Category III and IV banking organizations and extend that treatment to Category I and II banks. There is no basis for the Agencies to reverse the previously stated rationale and undo the beneficial impact of the simplified deduction framework they finalized in 2019.

- Second, in the alternative, the Agencies could impose an individual threshold of 15 percent of CET 1 capital for DTAs, MSAs and significant investments in UFIs and an aggregate threshold of 25 percent of CET 1 capital.

[40] 82 Fed. Reg. 49984, 49985-87 (Oct. 27, 2017); 84 Fed. Reg. 35234, 35236-37 (July 22, 2019).
[41] 84 Fed. Reg. 35234, 35237 (July 22, 2019).
[42] 88 Fed. Reg. 64028, 64037 (Sept. 18, 2023).

- As a third alternative, the Agencies could exclude MSAs from the aggregate cap and impose an individual threshold of 15 percent.

Our second and third alternatives are premised on the fact that the risks associated with MSAs are not the same as the risks posed by DTAs and equity investments in UFIs. In times of stress, DTAs and investments in UFIs may lose most, if not all, of their value. That is not the case with MSAs.

Finally, there is a longer-term issue here that should be addressed. We recommend that the Agencies undertake a review of the 250 percent risk weight for MSAs. Given the positive attributes of MSAs for banks engaged in financing mortgages and the market improvements in the valuation of these assets, the 250 percent risk weight is excessive. The volatility of MSAs value is driven in large part by how servicing is compensated. As part of this review of MSAs, the Agencies, through FSOC or otherwise, should coordinate with FHFA and Ginnie Mae regarding changes in the structure of mortgage servicing compensation. Restructuring mortgage servicing compensation could further reduce the volatility of servicing values,[43] and permit a reduction in the 250 percent risk weight for MSAs. Also, the biggest operational and financial risk in mortgage servicing occurs in the government-insured loan segment (loans securitized through Ginnie Mae). Yet these risks are driven by program rules of the government insurance programs (e.g., the Federal Housing Administration – FHA). Thus, these risks could, and should, be reduced by modernizing those program rules to better align with new mortgage servicing practices and program requirements.

G. Treatment of Mortgage Insurance and Other Forms of Risk Transfer

The Proposed Rule fails to recognize the benefits of structures that distribute mortgage credit risk to various intermediaries in the nation's financial system.

The Proposed Rule does not consider mortgage insurance (MI) in determining the LTV or risk weights for residential mortgages. Smaller banking organizations (those with less than $100 billion in assets) may continue to consider MI for determining if a loan has been prudently underwritten and may recognize MI in effectively lowering a loan's LTV under that standard approach.

The Agencies explain that the proposed treatment of MI is consistent with the current capital rule's definition of eligible guarantor, which does not recognize an insurance company engaged predominately in the business of providing credit protection, and that it reflects the performance of private mortgage insurance during times of stress in the housing market. While it is true during the 2008 financial crisis three mortgage insurance companies were placed into receivership by their state insurance regulators and are not approved to write new business, they still continue to pay claims, collect premiums, and provide critical credit risk protection. More importantly, the Agencies fail to recognize the significant changes in the industry since the financial crisis and the effective changes in oversight of MI companies since then. Those changes include both revisions to the master policies that enhance contractual certainty on how and when valid claims are paid, and the requirement that MI companies meet prudential standards established by FHFA and implemented through the Enterprises.

In the past fifteen years, private mortgage insurers have continued to improve their capital positions, which, for most MI companies, are now regularly monitored pursuant to the Private Mortgage Insurer Eligibility Requirements ("PMIERs") adopted by the Enterprises. The PMIERs are operational and

[43] Karan Kaul, Laurie Goodman, Alanna McCargo, and Todd Hill-Jones, *Options for Reforming the Mortgage Servicing Compensation Model, Urban Institute*, April 2019. ("Any changes to [mortgage servicing compensation] will have implications for the scope of servicer responsibility, mortgage servicing rights (MSR) values and liquidity, servicer revenues, profitability, and customer service.")

capital requirements that demonstrate that the MI companies "have adequate liquidity and claims-paying capacity during periods of economic stress."[44] Private mortgage insurers must meet these standards to be approved to insure loans acquired by the Enterprises.

In addition to enhanced financial strength, private mortgage insurers have also implemented – with significant input from FHFA and the Enterprises – a standard insurance contract or "master policy" that bolsters the dependability of the private MI industry. This new master policy includes increased clarity of terms that enforce the reliability and predictability of insurance claim payments to lenders when mortgages default. In addition, rescission of MI coverage is subject to temporal limitations and is only permitted for material loan defects that, had the defect been known at the time of origination, would have rendered the loan ineligible for mortgage insurance coverage.

The Proposed Rule also does not acknowledge the benefits of other risk transfer structures. While the Federal Reserve Board has issued FAQs on securitization,[45] some HPC members have indicated that more flexible guidance is needed to facilitate the use of credit risk transfers, including credit linked notes. Credit risk transfers promote several important public policy objectives. They attract a broad set of investors that analyze and price the mortgage credit risk and that assume some of that risk using their own capital. They reveal actual market prices for the mortgage credit risk, which proves useful during periods of market strength and weakness. They facilitate the effective deployment of capital, maximizing pricing efficiency and benefiting home buyers by lowering mortgage rates.

Recommendation: The Proposed Rule should recognize MI and other forms of credit risk transfer.

We recommend that the Agencies revise the Proposed Rule to retain existing treatment of MI if the coverage is provided by a company writing business under a uniform master policy and in good standing as an eligible MI counterparty to the Enterprises, which requires compliance with the PMIERs. Finally, we also recommend that the Agencies modify the capital regulations to facilitate the development of other forms of credit risk transfer, that are subject to robust regulatory standards and oversight, as these structures help distribute mortgage risk throughout a broader financial ecosystem.

H. Warehouse Lending / Lines of Credit

Currently, warehouse lines that are unconditionally cancellable are subject to a 0 percent CCF, warehouse lines with a duration of less than one year are subject to a 20 percent CCF, and warehouse lines with a duration over one year are subject to a 50 percent CCF. The Proposed Rule would impose a 10 percent credit conversion factor ("CCF") for commitments that are unconditionally cancellable, regardless of the duration of the commitment, and a 40 percent credit conversion factor for commitments that are not unconditionally cancellable, again regardless of the duration of the commitment. Certain commitments, such as revolving underwriting facilities would be subject to a 50 percent CCF.

We do not oppose these increased CCF amounts as they relate to mortgage warehouse lines because HPC has consistently advocated that bank-provided warehouse lines that are not unconditionally cancellable should be recognized by the Agencies, FHFA, Ginnie Mae, and the Enterprises as funding commitments that count as available liquidity for nonbanks.[46] However, under the

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[44] See: https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/PMIERs/PMIERs-Overview.pdf

[45] See: https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.html

[46] See letter from Edward J. DeMarco, President, Housing Policy Council to Alfred M. Pollard, General Counsel, Federal Housing Finance Agency on Enterprise Capital Requirements, November 16, 2018; and letter from Edward J. DeMarco, President Housing Policy Council to Sandra L. Thompson, Acting Director, Federal Housing Finance Agency on Re-Proposal to Enhance Eligibility Requirements for Enterprise Single-Family Seller/Servicers, April 25, 2022.

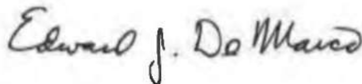
Proposed Rule, banks that provide these warehouse lines will be faced with higher required capital for the unused portion of these lines and can be expected to pass-on this additional cost to their nonbank clients, who will likely pass this cost to borrowers.

In sum, warehouse funding is critical to maintain liquidity of the mortgage origination pipeline and the default servicing of securitized mortgages. FHFA, Ginnie Mae, and state bank supervisors responsible for setting liquidity requirements for nonbank lenders and servicers need to share a common view with the Agencies as to the reliability of those lines. In particular, paid for commitments should be backed by bank capital and should be a reliable source of credit even during periods of tight liquidity.

IV. Conclusion

The Proposed Rule continues a policy approach by the Agencies since the 2008 financial crisis that has discouraged banks from originating and servicing mortgage loans. It is difficult to reconcile this policy with other long-standing public policies that promote home ownership and the many statutory, regulatory, and business practices improvements in mortgage lending and mortgage insurance that have occurred since 2008.

Yours truly,



Edward J. DeMarco
President
Housing Policy Council

Attachment: Responses to the Agencies' Single-Family Mortgage-Related Questions

Appendix

Responses to the Agencies' Single-Family Mortgage Related Questions

Question 23: *The agencies seek comment on the application of prudent underwriting standards in the proposed definitions of regulatory residential and regulatory commercial real estate exposures, including standards relating to the loan amount as a percent of the value of the property. What, if any, further clarity is needed and why?*

As mentioned in our comments, we recommend the Agencies consult with FHFA on their research and development of the ERCF which requires a more granular assessment of the risk of mortgage exposures including consideration of LTV ratios, FICO scores, debt-to-income ratios, owner-occupancy, the dependency on rental income, and the impact of credit risk mitigants such as mortgage insurance and credit risk transfers. See Section III. A. of our comment letter.

Question 24: *What, if any, alternative quantitative threshold should the agencies consider in determining whether a real estate exposure is dependent on cash flows from the real estate (for example, a threshold between 5 and 50 percent of the income)? Further, if the agencies decide to adopt an alternative quantitative threshold, either for regulatory residential and or regulatory commercial real estate exposures, how should it be calibrated for regulatory residential and separately for regulatory commercial real estate exposures and what would be the appropriate calibration levels for each? Please provide specific examples of any alternatives, including calculations and supporting data.*

FHFA has studied this question and, in its ERCF, provides that investment properties, regardless the amount of dependent income, are assigned a 1.2 risk multiplier. We recommend that the Agencies consider aligning with FHFA's approach.

Question 25: *The agencies seek feedback on the proposed treatment of exposures secured by second homes, including vacation homes where repayment of the loan is not dependent on cash flows. What are the advantages and disadvantages of treating such exposures as regulatory residential real estate exposures? Would a different category be more appropriate for these exposures given their risk profile, and if so, describe which other category(s) of real estate exposures would be most similar and why. Please provide supporting data in your responses.*

FHFA has studied this question and, in its ERCF, provides that owner-occupied and second homes are assigned a risk multiplier of 1. We recommend that the Agencies align with FHFA's approach.

Question 26: *The agencies seek comment on the treatment of residential mortgage exposures where repayment is dependent on cash flows from overnight or short-term rentals, as such cash flows may not be as reliable as a source of repayment as cash flows from long-term rental contracts or the borrower's other income sources. What would be the advantages or*

disadvantages of treating residential real estate exposures dependent on cash flows from short term rentals similar to commercial real estate exposures dependent on cash flows?

FHFA has studied this question and, in its ERCF, provides that greater risk weights would apply to residential real estate where repayment is materially dependent on cash flows generated by the property. We recommend that the Agencies align with FHFA's approach.

Question 27: *What are the benefits and drawbacks of allowing readily marketable collateral and other acceptable collateral to be included in the value for purposes of calculating the LTV ratio? What are the advantages and disadvantages of providing specific discount factors to the value of acceptable collateral for purposes of calculating the LTV ratio such as the standard supervisory market price volatility haircuts contained in section 121 of the proposed rule? What alternatives should the agencies consider? Please provide specific examples and supporting data.*

As noted in our comments, the ERCF adjusts the LTV every six months based upon the market value of the property (a mark-to-market LTV or MTMLTV), subject to a countercyclical adjustment when home prices are meaningfully above or below their long-term trend (i.e., plus or minus 5 percent).

We recommend that the Agencies adopt this approach with one caveat: The first adjustment should be delayed until after 60 months after origination. This would mitigate procyclical impacts of MTMLTVs. See Section III. B. of our comment letter.

Question 28: *The agencies seek comment on how the proposed treatment of regulatory residential real estate exposures will impact home affordability and home ownership opportunities, particularly for LMI borrowers or other historically underserved markets. What are the advantages and disadvantages of an alternative treatment that would assign a 50 percent risk weight to mortgage loans originated in accordance with prudent underwriting standards and originated through a home ownership program that the primary federal regulatory agency determines provides a public benefit and includes risk mitigation features such as credit counseling and consideration of repayment ability?*

The excessive risk weights inevitably will result in reduced mortgage lending by large banking organizations and/or increased fees to consumers, especially those in the higher LTV categories.

Regarding an alternative treatment for loans that provide a public benefit, HPC supports programs designed to assist low- and moderate-income home buyers or other historically underserved markets. However, we **oppose** an alternative treatment to set the capital requirement on a factor other than risk. Rather than seeking to make exceptions to the proposed framework, the Agencies should fix the proposed framework to be analytically aligned with the actual risk. See Section III. A. of our comment letter.

What, if any, additional or alternative risk indicators should the agencies consider, besides loan-to-value or dependency upon cash flow for risk-weighting regulatory residential real estate exposures? Please provide specific examples of mortgage lending programs where such factors were the basis for underwriting the loans and the historical repayment performance of the loans in such programs. Please comment on whether these risk indicators are already collected and maintained by banking organizations as part of their mortgage lending activities and underwriting practices.

The FHFA's ERCF relies on more than LTV and property occupancy. This framework, which includes credit scores and other risk-layering features, is a reasonable model for the Agencies to examine. The risk indicators used in the ERCF are all collected and maintained by banking organizations as part of their mortgage lending activities and underwriting.

Question 29: *The agencies seek comment on assigning risk weights to residential mortgage exposures, consistent with the current U.S. standardized risk-based capital framework. What are the pros and cons of this alternative treatment?*

HPC disagrees with this approach, at least for large banking organizations. The risk across millions of mortgages is highly variable but easily measured. A robust risk-based capital rule should utilize readily observable risk metrics to adjust the required capital at the loan level. The problem with the current framework is that the risk weights bear no analytical relationship to risk. The Agencies should consider offering LTV-based risk weights to all banking organizations regardless of size.

Question 30: *What, if any, market effects could the proposed treatment have on residential and commercial real estate mortgage lending and why? What alternatives to the proposed treatment or calibration should the agencies consider? Please provide supporting data.*

As mentioned in our comments, the divergent treatment under the Proposed Rule and the ERCF likely will result in shifting even more mortgage origination and servicing activity out of the banking system. It will also increase the market dominance of Fannie Mae and Freddie Mac (the Enterprises) by reducing bank funding and securitization of residential mortgages. Prime loans financed by banks will face significantly higher capital charges for credit risk than the Enterprises incur, as a result of the risk weight add-ons. The ability of banks to price for the added capital is severely limited and is nonexistent for most mortgages, given the Enterprises' liberal conforming loan limit. That limit – more than $1 million in higher cost areas and more than $766,550[47] in the rest of the country – means those loans can be financed through the already subsidized Enterprises, which can hold those same loans with significantly less capital than banks subject to the Proposed Rule. This type of regulatory capital arbitrage contributed directly to the 2008 financial crisis.

[47] 2024 Conforming Loan Limit Values, Federal Housing Finance Agency, November 28, 2023.

The Agencies should accept the recommendation of FSOC and coordinate the treatment of bank capital with the ERCF. The risk weights embedded in that capital framework are based upon an extensive review of mortgage credit risk that takes into consideration factors beyond just LTV ratios. Since bank portfolios are the logical alternative to secondary market sales to the Enterprises and since prime bank portfolio loans generally perform better than Enterprise loans, the ERCF could be seen as conservative, but it certainly would create more consistent capital treatment of mortgage within the U.S. See our comments in Section III. A, especially Table 1.

Question 124: *The agencies request comment on requiring banking organizations to apply a 35 percent correlation parameter for Uniform Mortgage-Backed Securities. What alternative correlation parameter should the agencies consider for Uniform Mortgage-Backed Securities and why?*

The 35 percent correlation parameter for UMBS is appropriate. However, the proposal is confusing as to the treatment of these securities and the to-be-announced (TBA market). One section implies that it may not be possible for banks to net pools against UMBS TBAs while another makes it seem like such netting would be permitted.

We recommend that the Agencies reaffirm that banking organizations are permitted to net Fannie or Freddie pools against UMBS TBA hedges; elimination of this netting would force dealers to bifurcate the TBA market into strict Fannie and Freddie strips (or their own TBAs) and would effectively undermine the UMBS project.

The Agencies should clarify that netting pools against UMBS TBAs is permitted.

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