Comments for the Record

Enterprise Capital Requirements

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Attention: Comments/RIN 2590–AA95

Federal Housing Finance Agency

Eighth Floor, 400 Seventh Street SW

Washington, DC 20219

Re: Enterprise Capital Requirements (RIN) 2590–AA95

To Whom it May Concern:

The American Action Forum ("AAF") experts appreciate the opportunity to submit comments on the notice of proposed rulemaking ("proposed rule") amending capital requirements for the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") ("collectively, the Enterprises"). This rule has been proposed by the Federal Housing Finance Agency ("FHFA") and the Office of Federal Housing Enterprise Oversight ("OFHEO") within the Department of Housing and Urban Development ("HUD") (collectively the "Agencies").

AAF is an independent, nonprofit 501(c)(3) organization. Its focus is to educate the public about the complex policy choices now facing the country and explain as cogently and forcefully as possible why solutions grounded in the center-right values that have guided the country thus far still represent the best way forward for America's future.

As one of this comment's authors noted in a dissenting statement to the Financial Crisis Inquiry Commission's report on causes of the financial crisis of 2007-2008, "Fannie Mae and Freddie Mac did not by themselves cause the crisis, but they contributed significantly in a number of ways…as large financial institutions whose failures risked contagion, they were massive and multidimensional cases of the too big to fail problem. Policymakers were unwilling to let them fail…."

After deeming the Enterprises "too big to fail," the FHFA took them into financial conservatorship and suspended their capital requirements. What was always expected to be a temporary solution has not proven to be so, and 10 years after the Enterprises remain in conservatorship. This status quo is not sustainable. The process of socializing losses and privatizing profits is not a viable long-term solution, and the Enterprises must be returned to the responsibility of their shareholders.

Ten years after the Housing and Economic Recovery Act (HERA) introduced safety and soundness regulations that included requiring the FHFA Director to advance a risk-based capital framework for the Enterprises, the FHFA has at long last released a proposal to do precisely that. The proposal would require that the Enterprises hold in capital the higher of a minimum leverage ratio or a risk-based capital requirement. The FHFA's proposal, however, would only go into effect if the Enterprises are removed from conservatorship and recapitalized. In materials accompanying the proposal, the FHFA made it clear that this proposal is not a route toward Enterprise reform but is itself predicated entirely on the Enterprises already being removed from conservatorship. As there is no roadmap toward this action, this proposed rulemaking appears to be based entirely on a hypothetical.

Determining the capital requirement that would be applied to the Enterprises, without having articulated how the Enterprises might be released from conservatorship, is to put the cart before the horse. The recapitalized Enterprises will presumably have entirely different charters and mandates; they will have fundamentally different balance sheets and risk appetites, both of which will drive significant differences in pricing structures. A key element is the risk-based capital requirement – yet how can we appropriately price risk for what is currently a public body? In publishing this proposal, the FHFA has given access to data look-up tables but has not provided the econometric models used to reach its conclusions, demonstrating that transparency remains a missing element in housing reform. Determining an appropriate capital requirement regime without these perspectives is a task both Herculean and Sisyphean.

Broader philosophical questions remain to be asked. In determining the minimum leverage ratio the FHFA has proposed two models: the first, in the spirit of the Basel requirements, would require that the Enterprises hold capital equal to 2.5 percent of total assets; the second, following the 1992 Federal Housing Enterprises Financial Safety and Soundness Act, would require that the Enterprises hold capital equal to 1.5 percent of trust assets and 4 percent of non-trust assets.

There is no question that were the Enterprises to be released from conservatorship they would be considered systemically important financial institutions (SIFIs). The Dodd-Frank Act Stress Tests (DFAST) conducted by FHFA this past summer indicate that given their current business activities and regulatory framework, the Enterprises still pose a significant threat to the financial system. The FHFA's proposal, however, does not expressly consider the systemic nature of the Enterprises at all. Further, the FHFA presents a conflicted message on asset diversification, noting that while the monoline nature of the Enterprises' business is, in the view of the FHFA, a positive feature with regard to capital standard setting, at the same time diversity is attractive when it comes to counterparty risk. How can both approaches be valid?

It would seem that any capital requirements considered by FHFA would need to be considered in light of Basel requirements, but this raises its own questions. The Basel Accords are based on the business of banks, and the appropriateness of Basel requirements to the Enterprises is unclear. Pre-crisis the Enterprises held investment portfolios of $900 billion each, representing a tremendous liquidity risk. Today that figure is in the region of $250 billion each – although still a risk, the Enterprises' portfolios now arguably have more in common with large insurers than large banks. Capital requirements are by nature procyclical, which is difficult to square with the countercyclical mandate of the Enterprises.

Assuming, however, that capital requirements are necessary, the exact quantum remains a difficult calibration. Too low and of course the Enterprises would not be adequately capitalized in a crisis; too high and the cost of capital, along with the cost of mortgages, would significantly increase. The 2.5 percent minimum leverage ratio put forward by one aspect of the proposal appears low by comparison to the 5 percent minimum applied to community banks, which have fundamentally less risky business models, let alone the capital requirements that apply to the SIFIs, ranging from 12 to 18 percent. Significant legislative efforts in Congress (both the Johnson-Crapo initiative and the Corker-Warner bill) fixed on 10 percent as being the appropriate gauge. How then to justify 2.5 percent? The second model would require the Enterprises to hold capital equal to 1.5 percent of trust assets and 4 percent of non-trust assets. Although this would require the Enterprises to hold significantly more capital than the 45 basis points required by the 1992 Federal Housing Enterprises Financial Safety and Soundness Act, it would still mean pinning capital requirements to the same law that governed the Enterprises going into the financial crisis; in addition, such a system would allow the Enterprises to "game" the system in asset definition.

In this proposal the FHFA has removed itself from the process of housing market reform. This need not be the case; the FHFA Director is empowered to remove the Enterprises from conservatorship without an act of Congress. Although detailed discussion as to the regulations that would apply to the Enterprises post-reform is welcomed, it cannot replace discussion as to reform itself. Without a fully articulated view of the role of government in housing policy, and the format of the Enterprises post-reform, to consider capital requirements is to construct elaborate castles in the air and on speculative data. The highly volatile nature of the housing market and the inelasticity of housing supply suggests that the Enterprises will play a key role in the next financial crisis. Conservatorship was only ever intended to be a stop-gap measure, and the need for housing market reform is more pressing than ever.

AAF stands ready to provide research and additional assistance to the FHFA and other interested parties as needed.

Sincerely,

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