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August 28, 2020

By Electronic Delivery Through the FHFA Website

Mr. Alfred Pollard
General Counsel, Federal Housing Finance Agency
Constitution Center, Eighth Floor (OGC)
400 7th Street SW
Washington, DC 20219

Re: Notice of Proposed Rulemaking on Enterprise Regulatory Capital Framework
Comments/RIN 2590-AA95

Dear Mr. Pollard:

Attached are the comments of Freddie Mac on the proposed Enterprise Regulatory Capital Framework published by the Federal Housing Finance Agency in the *Federal Register* on June 30, 2020.

Freddie Mac appreciates the opportunity to provide our views on the proposed rule. Please contact me if you have questions or require any further information.

Sincerely,

Ricardo Anzaldua
Executive Vice President, General Counsel and Corporate Secretary

Attachment

FREDDIE MAC

COMMENTS ON PROPOSED ENTERPRISE REGULATORY CAPITAL FRAMEWORK
August 28, 2020

EXECUTIVE SUMMARY

Freddie Mac supports a robust, risk-sensitive capital framework to incentivize strong risk management and bolster its mission to provide liquidity, stability and affordability to the U.S. housing market in all economic conditions and to all communities.

Establishing a robust capital framework is an important step toward the goal of a responsible exit from conservatorship for Freddie Mac and Fannie Mae (the "Enterprises"). Freddie Mac supports the overall goals of the Federal Housing Finance Agency ("FHFA") for the capital framework and, in particular, believes that the framework should enable each Enterprise to (i) be regarded as a viable going concern by creditors and counterparties even after a significant downturn or under stress and (ii) fulfill its mission to support the secondary mortgage market across economic cycles.

More specifically, we also agree that the proposed Enterprise Regulatory Capital Framework[1] should (i) utilize a mortgage-risk-sensitive framework, as the Enterprises are monoline entities focused on mortgage assets, (ii) increase the quantity and quality of the Enterprises' regulatory capital to levels sufficient to ensure safe and sound operations, sustained independence and significantly reduced reliance on taxpayers after exiting conservatorship, and (iii) address the inherent procyclicality in FHFA's 2018 capital proposal.[2]

In supporting FHFA's overall goals, we recommend certain guiding principles as FHFA finalizes the capital framework:

- **Ensure that risk-based principles govern the capital framework**. Fixed measures (such as floors or the leverage ratio) have the potential to deter risk-reduction efforts because an Enterprise cannot improve on the static requirement. Using dynamic and risk-sensitive calibrations in the capital framework encourages risk reduction and incentivizes strong risk management, resulting in a more integrated capital framework. More specifically, the risk-based capital requirements should be the binding measure in most economic circumstances, and a binding leverage ratio serves to reduce risk sensitivity.

- **Tailor the framework to the business of the Enterprises.** While the U.S. bank capital framework may provide a useful precedent, the Enterprises' business models and risk profiles are substantially different from those of banks. In contrast to banks, the Enterprises are pass-through, monoline businesses focused on a traditional, well understood and secured asset class. The Enterprises also transfer a substantial portion of credit and market risk to the market. These differences result in comparatively and materially lower risk retention and, thus, lower risk profiles for the Enterprises as compared to banks. In addition, the Proposal incorporates several complex elements from the bank framework that bank regulators have recently determined to modify based on their extensive experience with the framework.

- **Include only necessary countercyclical measures**. Limiting a capital framework's procyclicality is an important objective. However, we believe that this objective could be

[1] Enterprise Regulatory Capital Framework, 85 Fed. Reg. 39,274 (June 30, 2020) (the "Proposal").

[2] Enterprise Capital Requirements, 83 Fed. Reg. 33,312 (July 17, 2018) (the "2018 Proposal").

sufficiently accomplished through fewer layers. Risk sensitivity is an overall goal for the capital framework, and imposing what we believe are redundant requirements would reduce risk sensitivity. In addition, the final capital framework should provide FHFA with discretion to adjust capital requirements and buffers downward whenever further support of the secondary mortgage market may be needed.

- **Minimize unintended effects on the market and on the Enterprises' ability to fulfill our mission.** The Proposal may require Freddie Mac to increase guarantee fees by 15-35 basis points ("bps"), which may increase housing costs for U.S. consumers. Certain negative effects on our business and in the markets may arise from this increase. The capital framework should complement our countercyclical mission by strengthening the Enterprises and right-sizing capital requirements based on what we believe to be the Enterprises' actual risk profiles. In addition, the capital framework should continue to encourage development of the single security initiative, which improves liquidity and fungibility in the to-be-announced ("TBA") market, leading to a more efficient, resilient and liquid secondary mortgage market and furthering the Enterprises' ability to support these markets.

Our comments are intended to assist FHFA in accomplishing its overall goals for the capital framework, with increased capital to promote resiliency and appropriately calibrated requirements. In general, our comments seek to increase the risk sensitivity of the capital framework and to correlate required capital more closely to the true economic risk of our exposures. Our most material recommendations are highlighted below and described in more detail in the main body of this comment letter.

- Risk-Based Capital Requirements

  - The 15% risk-weight floor for single-family and multifamily mortgages should be removed to advance FHFA's goal of a risk-sensitive capital framework.

  - We generally support the risk weights and haircuts assigned in the look-up tables. However, the grids and risk multipliers should be adjusted in a few targeted ways to better match the risk posed by particular assets.

  - We recommend that multifamily exposures be subject to their own countercyclical adjustment, calibrated using U.S. long-term vacancy rates.

  - The 20% risk weight for commingled and crossholdings of Enterprises' mortgage-backed securities ("MBS") should not be adopted. These activities do not increase systemic or taxpayer risks since each Enterprise would already be holding capital for the credit risk associated with these MBS.

  - We agree that certain of the Enterprises' assets should be subject to a market risk capital requirement. However, certain exposures should not be double counted as both credit risk and market risk.

- Credit Risk Transfer ("CRT") Benefits

  - The capital framework should recognize the risk-reducing nature of CRT and the historical policy support provided by FHFA and Treasury to develop the CRT program.

    - The 10% risk-weight floor should be replaced with a 25% increase in the detachment level necessary to achieve full stress-scenario loss protection.

    - The 10% haircut on third-party tranches should be replaced with a modified process for applying an overall effectiveness adjustment ("OEA") only to certain CRT transactions.

- Leverage Ratio Requirements

  - The Proposal's leverage capital requirements should be revised to ensure that fixed measures such as the leverage ratio are ordinarily not binding constraints. Instead, risk-based measures should govern in most economic scenarios.

  - We recommend adopting the bifurcated approach in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended (the "Safety and Soundness Act"), and as presented again in the 2018 Proposal. We recommend a Tier 1 (in contrast to core) capital ratio to on-balance-sheet "held" assets of 4.00% and a Tier 1 capital ratio to the unpaid principal balance ("UPB") of guaranteed assets of 1.50%.

- The Prescribed Capital Conservation Buffer Amount ("PCCBA")

  - The static stress capital buffer of 0.75% of adjusted total assets ("ATA") should be replaced with a measure based on stress testing performance. We recommend sizing the stress capital component of the PCCBA based on the quarter with the largest cumulative losses over the Dodd-Frank Act stress test ("DFAST") stress horizon under the severely adverse scenario.

  - The stability capital buffer component should be replaced with FHFA's alternative proposal to adopt the buffer generated by the Board of Governors of the Federal Reserve System's (the "Federal Reserve's") "Method 1" global systemically important bank ("G-SIB") systemic risk scoring methodology.

  - The countercyclical capital buffer component should not be adopted.

- Advanced Approach for Credit and Market Risk

  - We recommend that the advanced approach for credit and market risk not be adopted. The requirements of the standardized approach developed by FHFA, particularly with regard to mortgage exposures, are sufficiently risk sensitive.

- Operational Risk

  - We support the use of a modeled, risk-based framework for operational risk; the final capital framework should:

    - Permit a lower loss-confidence interval than 99.9% to reduce volatility in potential outcomes; and

    - Reduce the operational risk capital floor from 15 bps to 8 bps of ATA to ensure it is calibrated as a backstop to risk-sensitive measurement approaches rather than a binding floor.

- Compliance Period

  - The final capital framework should incorporate an appropriate phase-in period, beyond the effective date of any final rule, given the projections in the Proposal that the Enterprises would need to substantially increase our capital and provide acceptable returns in the form of distributions to investors.

  - The final capital framework should clarify the timing of resumed Prompt Corrective Action ("PCA") capital classifications for the Enterprises and the extent to which any classification-related restrictions on capital distributions or other actions would apply during any phase-in period while the Enterprises are raising capital.

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I. Introduction and Guiding Principles in Support of Freddie Mac's Recommendations

A. *Establishing a post-conservatorship capital framework is important to supporting the mission of the Enterprises and demonstrating our viability as going concerns—and thereby protecting taxpayers and avoiding the need for government intervention—even after a significant downturn or stress event.*

Freddie Mac agrees with FHFA that a robust post-conservatorship capital framework should be designed to ensure that the Enterprises operate in a safe and sound manner and provide stability and ongoing assistance to the housing market. To that end, Freddie Mac endorses FHFA's overall goals set forth in the Proposal. Specifically, the capital framework should enable each of the Enterprises to (i) be regarded as a viable going concern by creditors and counterparties even after a significant downturn or under stress and (ii) fulfill its mission to support the secondary mortgage market through economic cycles.[3]

We also support the three more specific objectives of the Proposal. First, we support the Proposal's preservation of the mortgage-risk-sensitive framework in FHFA's 2018 Proposal. The Enterprises are monoline entities focused on mortgage assets. Our statutory mission is to provide liquidity, stability and affordability to the U.S. housing market, which we achieve primarily by purchasing and guaranteeing residential mortgage loans originated by lenders and investing in mortgage loans and mortgage-related securities. Consequently, it is important that the capital framework applicable to the Enterprises reflect specific and granular calibrations sensitive to mortgage risks.

Second, we agree that the capital framework should increase the quantity and quality of the Enterprises' regulatory capital to a level commensurate with the Enterprises' risks and sufficient to ensure safe and sound operation, sustained independence and significantly reduced reliance on taxpayers after exiting conservatorship.

Finally, we support addressing the procyclicality of the risk-based capital requirements of the 2018 Proposal. As FHFA has noted, a procyclical framework could have incentivized the Enterprises to expand credit when housing prices increase and potentially left the Enterprises without sufficient capital that could be drawn down, and deployed in the market, during a period of financial stress. The macro-economic effects of this procyclicality could even exacerbate the housing price cycle itself.[4] In order to counter these negative effects, a procyclical framework could also have necessitated, as part of a prudent management strategy, the retention of a significant management buffer to be able to weather the volatility of expected capital levels at the beginning of any stress period. Retaining an excessive management buffer is inefficient for the Enterprises, as it means we would have less available capital to deploy to support the market.

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[3] Proposal at 39,284-85.

[4] *Id.* at 39,290.

B. *The adjustments we propose throughout these comments are designed to ensure that risk-based principles govern the capital framework in most economic scenarios, instead of a leverage ratio or other fixed measure functioning as the binding constraint.*

We have proposed adjustments to replace static calibrations with dynamic, risk-based measurement tools. For example, the static stress capital buffer of 75 bps on ATA should be replaced with a measure based on the DFAST severely adverse scenario, to which the Enterprises are already subject. Additionally, the stability capital buffer's market share approach should be replaced with FHFA's alternative proposal to adopt a modified version of the U.S. bank capital framework's G-SIB systemic risk score and capital surcharge.

We recommend the modification or elimination of several elements of the Proposal that we think have a high probability of becoming fixed, risk-insensitive measures, such as the high leverage ratio, the loan-level risk-weight floors and the operational risk floor. The leverage ratio should be a backstop, not a binding constraint in most economic scenarios; such fixed measures deter risk-reduction efforts because an Enterprise cannot improve on the static requirement. Using dynamic calibrations in the capital framework has the benefit of encouraging risk reduction and incentivizing strong risk management, resulting in a more integrated capital framework across the risk-based capital, stress testing and buffer requirements.

Finally, our proposed adjustments are also generally designed to simplify and improve the transparency and efficiency of the capital framework in instances where we think there is no benefit to be gained from additional complexity. For example, we recommend that application of the advanced approach be eliminated with respect to credit and market risk. The advanced approach would require a significant investment of time and money, as well as supervisory resources, for development of models in addition to those already in use. The combination of the risk-based standardized approach, stress testing, backstops and FHFA supervision of internal risk management models provides significant risk discipline to the Enterprises, obviating the need for parallel risk-weight analyses. In addition, the standardized approach is more transparent to market participants assessing the risk of the Enterprises than are internally developed models.

C. *The final capital framework should be tailored to the business and risks of the Enterprises, while incorporating recent adjustments to the U.S. bank regulatory capital framework.*

1. <u>The quantity and quality of capital required should be tailored to the Enterprises' business and risk profile.</u>

In re-proposing the Enterprise capital framework, FHFA relied heavily on the U.S. bank capital framework. While the U.S. bank capital framework may provide a useful precedent in some respects, the Enterprises' business models and risk profiles are substantially different from those of banks. A regulatory capital framework for the Enterprises will be effective only if it is calibrated to take into consideration these significant differences. Importantly, the bank capital framework was designed by the U.S. banking agencies to cover thousands of banks in the United States, which are engaged in diverse businesses of varying risk,

scale and complexity. FHFA, on the other hand, has an opportunity to create a framework for Freddie Mac and Fannie Mae that is tailored to our specialized businesses and risk profiles.

In particular, a capital framework should take into account the following unique characteristics of the Enterprises:

- The Enterprises are pass-through businesses. Freddie Mac does not engage in principal-risk financial intermediation or maturity transformation for over 85% of our consolidated assets. The majority of the Enterprises' balance sheets are match-funded with MBS, which substantially transfer liquidity and interest rate risk to the market. Investors purchasing Enterprise MBS understand that they are assuming interest rate risk, and there is no expectation of insulation from such risk. One must look through the lens of this pass-through, match-funded model when characterizing the Enterprises' balance sheets. While accounting requirements in some instances cause us to gross up our balance sheets, the large balance sheets are deceptive—the Enterprises actually carry significantly fewer assets and less risk than our balance sheets would indicate, in sharp contrast with the balance sheets of banks. Banks do not operate as fully match-funded or as solely pass-through entities. Banks generally take full intermediation risk as a principal for interest rate, liquidity and maturity mismatch on a significant portion of their balance sheets.

- The Enterprises transfer a substantial portion of credit risk to the market through CRT. CRT transactions are arrangements through which we actively transfer the credit risk exposure on mortgages that we own or guarantee. Freddie Mac's single-family CRT programs include securities issuances, insurance/reinsurance transactions, senior-subordinate securitizations and a variety of lender risk-sharing transactions.[5] Freddie Mac's multifamily CRT program focuses on senior-subordinate structures via capital markets transactions. Through the end of 2019, Freddie Mac transferred 89% of the allocated credit risk capital for single-family, and 91% for multifamily, on 2018 acquisitions that are part of CRT reference pools for transactions conducted in 2018 and 2019.[6] In contrast, banks do not generally engage in CRT of the same type, and certainly not to the same extent, as the Enterprises.[7] Banks also typically take full credit risk on much of their balance sheets. Additionally, the mortgages underlying the CRT transactions are less risky than activities that banks typically engage in, such as leveraged lending and speculative construction lending.

- The Enterprises are monoline businesses focused on a traditional, well understood and secured asset class.

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5 FHFA, *Credit Risk Transfer Progress Report* (Fourth Quarter 2019), at 2, https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Progress-Report-4Q2019.pdf ("FHFA CRT Report").

6 *Id.* at 3 (single-family) and 9 (multifamily).

7 *See* Laurie Goodman, Urban Institute, *Credit Risk Transfer: A Fork in the Road* at 15 (June 2018), https://www.urban.org/sites/default/files/publication/98578/credit_risk_transfer_a_fork_in_the_road_0.pdf.

- We have simpler balance sheets and engage in less capital-intensive and less risky activities than banks of similar size. Banks in general engage in the business of maturity transformation—taking demand deposits and other short-term liabilities and using the proceeds to purchase or originate longer-term assets such as commercial and consumer loans. The resulting maturity mismatch can expose banks to greater risks of funding volatility during periods of market and economic stress, thereby creating the risk of a "run on the bank," resulting in the need for greater capital. The Enterprises, by contrast, do not engage in any maturity-mismatched operations entailing the need for additional capital.

- Large banks in particular engage in more businesses that regulators deem "complex," such as prime brokerage, derivatives and securities dealing and clearing, and securities underwriting. In contrast, the Enterprises have less operational and balance-sheet complexity. The Enterprises cannot take deposits or originate loans; rather, they may only purchase loans from originating lenders. The Enterprises also do not carry out primary servicing on loans. The narrower scope of our overall activities significantly reduces complexity and operational costs in comparison to banks.

- Banks also engage in riskier lending activities. For example, banks may engage in leveraged lending, including acquisition finance and leveraged buy-outs; acquisition, development and construction loans; unsecured business and retail loans; margin lending; and other types of lending in which the Enterprises do not engage. The mortgage asset class in which the Enterprises conduct business is secured and non-speculative, and the Enterprises' participation in the market is diversified across the credit, collateral and geographic spectrum. Even when looking only to mortgages, the Enterprises' portfolios exhibit materially less risk than banks. As shown by an analysis performed by Freddie Mac in relation to the Proposal, Freddie Mac consistently has a lower-risk mortgage portfolio than similar banks. This is demonstrated by two approaches that indicate a risk-weighted assets ("RWA") density that is approximately 60% of the density of the mortgage portfolios of U.S. commercial bank G-SIBs and selected regional banks.[8] All else being equal, the Enterprises maintain a less risky portfolio of mortgages because of the constraints placed on and adopted by the Enterprises, including the requirement to purchase qualifying mortgages ("QM") and the adoption of additional purchase restrictions by Freddie Mac that narrow further the permissible assets within our credit guidelines.[9] In addition, our overall loan loss reserves have consistently declined over the last several years.[10]

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[8] *See* footnote 124 and accompanying text.

[9] *See* footnotes 23-34 and accompanying text. We also note that our stress-scenario losses have been consistently decreasing over DFAST severely adverse scenarios for the last several years, in contrast to comparable banks. *See* Appendix G.1.

[10] Freddie Mac's allowance for credit losses has decreased from $15.4 billion, as of December 31, 2015, to $4.29 billion as of December 31, 2019. *See* Freddie Mac, Annual Reports on Form 10-K, for years ended December 31, 2019 (at 186) and December 31, 2016 (at 246).

- The Enterprises are U.S. entities that operate only in the United States. Most large banks are global businesses that operate across multiple jurisdictions and regulatory regimes, which is an additional layer of complexity that must be taken into account in a capital framework applicable to banks.

These differences in business models result in comparatively and materially lower risk retention—and thus risk profiles—for the Enterprises as compared to banks. This is reflected by Freddie Mac's lower aggregate RWA density than (i) U.S. commercial bank G-SIBs, including U.S. G-SIBs with large mortgage portfolios and (ii) selected regional banks that engage in significant retail and mortgage lending. As described below in Subsection IV.D, Freddie Mac's aggregate RWA density is within a range of 27-32% across three calculation approaches, while U.S. commercial bank G-SIBs' and selected regional banks' aggregate RWA density yields measurements in the range of 50-54%.[11]

Consequently, many of our recommendations on the Proposal seek to reduce complexity, increase risk sensitivity and improve integration of various components within the architecture developed by FHFA, by taking into account these specific characteristics of the Enterprises.

2. The final capital framework should reflect recent adjustments to the U.S. banking agencies' capital framework.

As noted above, there are strong reasons why applying bank capital rules to the Enterprises without appropriate tailoring may be ineffective. That said, to the extent that the final rule incorporates elements of the U.S. bank capital framework, FHFA should consider that the U.S. banking agencies have recently determined to revise substantially or phase out certain elements entirely. The last seven to ten years of implementation and modification of the U.S. banking agencies' capital framework provide valuable reference points. Importing elements of the framework that are now scheduled to be phased out would not take into account the considerable learning gained over this time period and would risk incorporating several complex, outdated and duplicative elements that have proven unduly burdensome or unnecessary.

For example, the Proposal would import the current enhanced supplementary leverage ratio ("eSLR") buffer applied to the supplementary leverage ratio ("SLR") applicable to the largest U.S. banking organizations, without incorporating recently proposed revisions to downsize this requirement in order to restore its role as a backstop, rather than a binding constraint. Similarly, the Proposal would impose a requirement to determine credit RWA using an advanced internal models-based approach, even though the U.S. banking agencies, based on their experience with these approaches, have indicated skepticism about continuing to use the advanced approaches in the bank capital framework going forward. Similar skepticism has been expressed internationally by the Basel Committee in its final revisions to the Basel III post-crisis reforms (commonly referred to as "Basel IV"). Further, there is less utility in implementing an advanced approach for credit risk for the Enterprises. The Proposal's standardized approach for determining RWA is specifically designed to be more risk-sensitive, requiring dynamic

[11] *See* footnote 124 and accompanying text.

adjustments to RWA when conditions or attributes change, in contrast to the less risk-sensitive approach for banks.

In addition, the Proposal should seek to reflect several recent lessons learned from the coronavirus ("COVID-19") pandemic, which has necessitated actions by the regulators to alter the bank capital framework to ensure its flexibility during times of stress. For example, the pandemic has demonstrated the importance of ensuring that non-risk-based leverage requirements and floors do not function as inflexible binding constraints and that add-on buffers do not impair the ability of financial intermediaries to assist the economy. This experience has highlighted the importance of maintaining adequate supervisory discretion to ensure that capital requirements are not overly procyclical, as the advanced approaches have proven to be in the current pandemic. Specifically, a number of G-SIBs became bound by the advanced approaches in the first quarter of 2020 because their advanced approach RWA exceeded their standardized approach RWA under Section 171 of the Dodd-Frank Act (also known as the "Collins Floor") for the first time in several years.[12] As a result, G-SIBs' capital requirements increased and credit availability was reduced, hindering the G-SIBs' abilities to respond to the economic challenges caused by the COVID-19 pandemic.

D. *The final capital framework should include only necessary countercyclical measures to increase risk sensitivity. In addition, the final capital framework should provide FHFA with discretion to adjust capital requirements and buffers downward when further support of the secondary mortgage market may be needed.*

We have proposed adjustments throughout these comments to reduce countercyclical measures in the Proposal that we consider to be redundant. Countercyclicality is layered in multiple ways throughout the proposed framework, including in the broad leverage ratio requirement across our asset base and in adjustments proposed at the asset level, the risk mitigant/CRT level and the overall risk-based capital level. While limiting a capital framework's procyclicality is an important objective, it can be sufficiently addressed through fewer layers and lower (or no) asset level or CRT floors. Redundant requirements reduce risk sensitivity in the capital framework and increase incentives for risk taking.

We support FHFA's reservation of authority to adjust the required ratios, the various numerators and denominators, and the countercyclical capital buffer. However, the Proposal would be more effective and dynamic if these reservations of authority unambiguously applied to all elements of the proposed capital framework. While we would expect the use of this authority to be rare, it should encompass the complete capital framework. Reserving discretion to make downward countercyclical adjustments to the capital buffers that ultimately apply to the Enterprises would be an effective use of FHFA's supervisory authority to ensure that the Enterprises can fulfill our charter obligations even in a stress scenario.[13] Varying buffers in line with the changing risks that the Enterprises face over time also would be consistent with the

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[12] *See* Louie Woodall, *Credit Models at Odds with the Standardised Approach on COVID Shock*, Risk (May 8, 2020).

[13] *See* Proposal at 39,369 (reserving authority to make a downward adjustment to the countercyclical capital buffer).

approach taken by the Basel Committee and bank regulators in the United States and other countries.[14] In addition, FHFA should explicitly reserve authority to modify the implementation timeline if conditions warrant. Allowing greater scope for dynamic adjustments to both the content and implementation timeline of the capital framework would be consistent with policies underlying the U.S. bank capital framework.[15]

E. *Unintended effects on the market should be minimized in order to enable the Enterprises to fulfill our missions.*

1. The capital framework should continue to encourage development of the single security initiative to increase the liquidity of the TBA and uniform mortgage-backed securities ("UMBS") markets.

Under the direction of FHFA, the Enterprises have implemented a single security initiative that is intended to increase the liquidity of the TBA market by supporting the fungibility of Freddie Mac and Fannie Mae securities. Pursuant to this initiative, the Enterprises issue a single (common) UMBS. We agree with FHFA that the new, consolidated UMBS market leads to a more efficient, resilient and liquid secondary mortgage market, furthering the Enterprises' ability to support the U.S. housing finance markets. Stakeholders agree that the UMBS market has been successful in delivering its goals of improving liquidity and fungibility in the TBA market.

The Enterprises' capital requirements should reflect these goals. As proposed, the new risk weight for commingling and cross-holdings of exposure to the other Enterprise could hinder the development of the UMBS market and related resecuritizations by increasing fees, negatively affecting UMBS fungibility and reducing incentives to participate in the market. Therefore, we recommend that the 20% risk weight for commingled and crossholdings of Enterprises' MBS be eliminated, consistent with the 2018 Proposal.

2. The capital framework should avoid unnecessary impacts on the economics of the secondary mortgage market and should avoid limiting the ability of the Enterprises to fulfill our missions throughout the economic cycle.

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[14] *See* Press Release, Basel Committee, Basel Committee meets; discusses impact of Covid-19; reiterates guidance on buffers (June 17, 2020), https://www.bis.org/press/p200617.htm ("[B]uffers have two objectives. First, to ensure that banks absorb losses in times of stress without breaching their minimum requirements. Second, to help maintain the flow of credit to the real economy in a downturn by lending to creditworthy businesses and households. Using capital resources to support the real economy and absorb losses should take priority at present. . . . The Committee views a measured drawdown of banks' Basel III buffers to meet these objectives as both anticipated and appropriate in the current period of stress."); Bank of England, *Statement by the PRA Accompanying Measures Announced by the Financial Policy Committee* (Mar. 11, 2020), https://www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-by-the-pra-accompanying-measures-announced-by-the-fpc ("The PRA reaffirms that buffers can be used as intended to continue to support the real economy during periods of stress.").

[15] *See* Randal K. Quarles, Vice Chair for Supervision, Federal Reserve, Refining the Stress Capital Buffer (Sept. 5, 2019), https://www.federalreserve.gov/newsevents/speech/quarles20190905a.htm.

A robust capital framework that preserves the Enterprises as going concerns supports the mission of the Enterprises to provide liquidity, stability and affordability to the U.S. housing market in all economic conditions. That mission is inherently countercyclical. The Enterprises should be participating in the housing market through the cycle, across geographies and across the credit spectrum with a full range of products, with equal access to mortgage originators and servicers of all sizes. The capital framework should complement that countercyclicality by strengthening the Enterprises.

The ability of the Enterprises to fulfill our countercyclical mission can be affected by the calibration of various elements of the proposed capital framework. Our comments seek to enhance our ability to execute our mission by right-sizing the calibration of that framework so that it focuses on what we regard as the Enterprises' actual risk profiles rather than what we regard as non-risk-based measures. Nevertheless, we understand that the path to exiting conservatorship requires sufficient capital so that the Enterprises may be independent, viable and vibrant participants in the housing market. We seek an appropriate balance, building the capital needed for ongoing resiliency without unduly altering the economic decision-making required to conduct our activities.

Achieving that balance, in our view, requires modifying the Proposal to eliminate what we regard as distortional elements that may negatively affect the Enterprises' ability to participate across the credit, collateral and geographic spectrum. It is true that increased capital requirements may cause us to raise guarantee fees. But the level of capital is not the only consideration. The incentives created by conservative measures and non-risk-based elements of the Proposal may shift our participation in, and the overall dynamics of, the secondary housing market. The layering of floors and other measurements in the Proposal that, in our view, do not size capital to the actual risk of an asset may have a disproportionate impact on the lower-risk segment of our acquisitions and portfolio, by driving capital higher, contrary to what we regard as this segment's true risk profile.

Segments of Freddie Mac's business would be affected differently, based on their relative price elasticity, by an increase in guarantee fees. In general, our lower-credit-risk loans are subject to greater pricing competition in the marketplace from banks, thrifts, credit unions, private label security ("PLS") originators, funds and other intermediaries. Consequently, if Freddie Mac increases guarantee fees, these lower-risk loans could receive a more economical outlet elsewhere. Originators make cost decisions when seeking to sell loans, and they expect the lower-risk segment of the market to attract higher prices (or lower guarantee fees).

Overall, we see the possibility of losing volume in low-credit-risk segments of the market when guarantee fees are increased. As Freddie Mac's current pricing generates higher returns from this segment, losing this market segment may result in a lower overall return on equity. In order to maintain an acceptable return on equity to attract private capital, Freddie Mac may have to raise guarantee fees across our acquisitions (likely to a greater degree on our higher credit-risk loans) to balance the lower volume of lower-risk loans. Raising guarantee fees on this segment could negatively affect underserved segments of the housing market, in contrast to the Enterprises' mandate to support affordability across the entire credit spectrum. Even though our higher credit-risk loans exhibit substantial price elasticity, Freddie Mac is still limited in our ability to increase guarantee fees on this segment sufficiently to offset the reduction in the

volume of lower-risk loans. If Freddie Mac raises guarantee fees on the higher credit-risk loan segment too much, these loans likely could receive more economical execution with the Federal Housing Administration or other government-supported buyers. Therefore, we could be competitively squeezed at both ends of the credit risk spectrum, resulting in Freddie Mac becoming an overall higher-risk entity that is less viable competitively and less able to support its affordable housing mission.

In order for Freddie Mac to conduct an independent and viable business, we need to attract private capital, and some elements of the Proposal could hinder our ability to do so. We envision various capital markets activities for several years in order to create a viable and vibrant public company with a return acceptable to investors. Modeling these post-conservatorship actions, and given the economic factors we highlight above, we estimate that the proposed capital framework may result in the need to increase Freddie Mac single-family guarantee fees on average across the portfolio by 15-35 bps. As noted, segments of our portfolio exhibit varied price elasticity. In order to maintain an appropriate return, an increase of 20-50 bps could be required on the higher-risk segments of our acquisitions to offset the loss of higher returns and volume on our lower-risk segment, affecting low-income, affordable housing.

A logical outgrowth of these effects could also be to increase the Enterprises' relative concentration in loans with higher risk, which would increase the Enterprises' capital requirements as a share of our assets. Moreover, this overall risk mix on our balance sheet and underlying our guaranteed securities would be transparent to investors, who may demand a greater return on their equity investments for the relatively higher risk profile. The Proposal's reduction in incentives to engage in CRT transactions could magnify the increase in our risk profile. With increased costs of capital, several additional effects may emerge.

First, in addition to raising guarantee fees, the Enterprises may need to seek greater returns, potentially entering a cycle of acquiring higher-risk assets and spending less on transferring this risk through CRT. Unlike banks, we are limited by our charters in the ways in which we may diversify to improve returns.

Second, our ability to participate in the housing market through the cycle could be reduced, as our pricing might be less competitive in upturns or robust markets. The extreme end of this trend is that the Enterprises may resemble a lender of last resort—shrinking in robust markets and being asked (because of our mission) to continue to participate in down-cycles when other originators are ready to offload assets. Similarly, geographic diversity may be affected due to the risk that the Enterprises become the targets of adverse selection. Sellers may be more willing to provide the Enterprises with assets originated in certain geographic areas experiencing greater risk and volatility in the housing markets. This could leave the Enterprises with an overrepresentation in our portfolio of riskier housing markets, even though geographic diversity is important to a well-balanced portfolio. Completing the circle, it could be harder to raise capital to increase purchases and market participation in a downturn from a position of a smaller balance sheet maintained in a more robust market.

It is important for the Enterprises to maintain our ability to execute our mission across credit cycles and across the credit spectrum, as well as to build and maintain solid balance sheets. The capital framework must allow our businesses to diversify and remain competitive.

Costs of capital should be commensurate with our true economic risk in order for the Enterprises to attract investors, become viable and independent entities and exit conservatorship. The Enterprises may not be able to fulfill these goals if the capital framework leads to the cyclical effects described above. The risk taken in a downturn, the volatility of the balance sheet through economic cycles and the potential that the Enterprises become lenders of last resort could cause investors to demand higher returns, which could impair the Enterprises' ability to attract sufficient capital to exit conservatorship and be viable as private entities.

Our comments generally seek to make the capital framework more risk-based. We recommend modifications to proposed elements, such as the leverage ratio, floors and other non-risk-based requirements, that we think could create distortions in pricing and decision-making by pegging, rather than differentiating, the required capital of lower-risk segments of our portfolio.

F. *Key recommendations on the Proposal.*

Our comments are intended to assist FHFA in accomplishing its overall goals for the capital framework, with increased capital to promote resiliency and appropriately calibrated requirements. In general, our comments seek to increase the risk sensitivity of the capital framework and to correlate required capital more closely to the true economic risk of our exposures. Our most material recommendations are highlighted below and described in more detail in the remainder of our comments.

1. Risk-Based Capital Requirements

- **The 15% risk-weight floor for single-family and multifamily mortgages should be removed to advance FHFA's goal of a risk-sensitive capital framework.**

  - The 15% risk-weight floor reduces the risk sensitivity of the capital framework, especially in light of the scope, varied risk profiles and materially lower loss history of the mortgage loans that would be subject to the floor. The floor would apply the same 15% risk weight to 62% of our 3Q 2019 single-family portfolio UPB and would cover significant segments of loans with cumulative loss histories (taking into account the financial crisis) that are a fraction of the 15% (or 120 bps) floor. Several of these low-risk segments have single-digit basis point cumulative loss histories.

  - The 15% floor could engender adverse selection in our portfolio by leading originators of lower-risk loans to find better pricing and execution in private markets, decreasing our volume in those segments while increasing the riskiness of mortgages available for us to acquire and guarantee in other segments.

- **We generally support the risk weights and haircuts assigned in the look-up tables. However, the grids and risk multipliers should be adjusted in a few targeted ways to better match the risk posed by particular assets.**

  - The single-family look-up tables should be modified to (i) split the 30-60% loan-to-value ("LTV") band into three segments (30-40%, 40-50% and 50-60%)

to increase risk sensitivity and (ii) eliminate the proposed refinance burnout multipliers, as any credit risk from cohort burnout would already be incorporated into the grids and multipliers developed based on the Enterprises' recorded loss histories.

- The multifamily look-up tables should be modified by (i) reducing the variance between base risk weights for fixed and adjustable rate mortgages, so as not to penalize floating-rate loans, as they exhibit credit risk profiles similar to our fixed-rate loans and (ii) applying a 0.60 risk multiplier to loans funded with low-income housing tax credits ("LIHTCs"), which have performed well.

- **We recommend that multifamily exposures be subject to their own countercyclical adjustment, calibrated using U.S. long-term vacancy rates.**

- **The 20% risk weight for commingled and crossholdings of Enterprises' MBS should not be adopted.** These activities do not increase systemic or taxpayer risks since each Enterprise would already be holding capital for the credit risk associated with these MBS. A high risk weighting could hinder further development of the UMBS market, which is a shared national policy goal among FHFA, the U.S. Department of the Treasury ("Treasury") and the Enterprises.

  - A counterparty credit risk weight of 20% for the Enterprises would increase capital beyond the Enterprises' aggregate total credit risk, layering additional capital whenever each holds or guarantees securities of the other. In addition, the risk weight would apply to Enterprise investments in UMBS, negatively affecting the Enterprises' provision of liquidity to the market.

  - The 20% risk weight for commingling and cross-holdings of MBS could undermine the common securitization platform and risks a return to a segregated market. By disincentivizing cross-holdings, the risk weight would encourage each of the Enterprises and the market to distinguish between Enterprise issuances, and could diminish UMBS market fungibility and liquidity.

- We agree that certain of the Enterprises' assets should be subject to a market risk capital requirement. **However, certain exposures should not be double counted as both credit risk and market risk**.

2. CRT Benefits

- **The treatment of CRT should be made more risk-based by (i) replacing the 10% risk-weight floor with a risk-based approach that encourages the purchase of additional protection and (ii) replacing the blanket 10% haircut on CRT tranches held by third parties with a more targeted approach.**

  - The capital framework should recognize the risk-reducing nature of CRT and the historical policy support provided by FHFA and Treasury to develop the CRT program. These transactions have resulted in a substantial increase in protection for single-family credit guarantee and multifamily mortgage portfolios, attracted

new and varied investors and additional private capital to the housing market, and reduced the risk of losses to the Enterprises and taxpayers if borrowers go into default. The Proposal's floors and haircuts encourage a reduction in the use of CRT, which would increase the Enterprises' retention of credit risk as well as potential taxpayer risk exposure.

- Our recommendations would incentivize the purchase of additional protection rather than decrease the use of CRT.

  - **The 10% floor should be replaced with a 25% increase in the detachment level necessary to achieve full stress-scenario loss protection.** The increased detachment creates a buffer to capture any perceived model risk and idiosyncratic risk and would incentivize purchase of greater protection by giving capital benefit above stress-scenario loss. Additional protection benefits taxpayers as well as capital investors.

  - **The 10% haircut on third-party tranches should be replaced with a modified process for applying an OEA only to certain CRT transactions.** Existing CRT transactions and transactions similar to those transactions do not require OEA. The Enterprises should be required to provide notification to FHFA of new CRT transactions materially different from existing transactions and of material changes to existing CRT programs, and we would work with FHFA to determine whether OEA may be necessary based on those material changes from existing structures.

3. Leverage Ratio Requirements

- **The Proposal's leverage capital requirements should be revised to ensure that fixed measures such as the leverage ratio are ordinarily not binding constraints. Instead, risk-based measures should govern in most economic scenarios.**

  - As proposed, with both on- and off-balance sheet items captured equally in the ATA denominator, the proposed leverage capital requirement would not be a backstop. Instead, it would operate as the binding capital determinant in most economic scenarios. We estimate the proposed requirements would constitute the binding capital determinant for Freddie Mac in (i) over the past 18 years, all but two or three years at the peak and end of the previous financial crisis and (ii) the DFAST severely adverse scenario over a nine-quarter forecast horizon.

  - A binding leverage ratio would effectively apply the same capital requirements to all exposures, thereby eliminating the risk-sensitivity that FHFA has sought to incorporate into the Proposal (and that we have sought to enhance through our comments).

  - A bank leverage capital requirement would not be suitable for the Enterprises given the significantly different business model, risk profile and liability structure of the Enterprises from those of banks.

- **We recommend adopting the bifurcated approach in the Safety and Soundness Act and presented again in the 2018 Proposal. We recommend a Tier 1 (in contrast to core) capital ratio to on-balance-sheet "held" assets of 4.00% and a Tier 1 capital ratio to the UPB of guaranteed assets of 1.50%.**

    - A better-suited leverage requirement approach for the Enterprises is reflected in the statutory capital requirements and the 2018 Proposal, which establish a necessary dichotomy between assets that an Enterprise holds and funds itself with short- or long-term debt or equity capital, and those assets that an Enterprise transfers and match-funds in full through long-term guaranteed debt issued to third parties.

4. The PCCBA

- The PCCBA components should be more risk-sensitive and dynamic.

- **The static stress capital buffer of 0.75% of ATA should be replaced with a measure based on stress testing performance. We recommend sizing the stress capital component of the PCCBA based on the quarter with the largest cumulative losses over the DFAST stress horizon under the severely adverse scenario.** In a severely adverse scenario, our stress capital buffer would be 0.52% of ATA (or 2.0% of RWA), including four quarters of dividends assumed to be 50% of retained net income. This stress capital component of the PCCBA would encourage proactive risk management and be subject to reset each year.

- **The stability capital buffer component should be replaced with FHFA's alternative proposal to adopt the G-SIB systemic risk buffer, taking into account certain adjustments.** The proposal to base this component on housing market share is a proxy for size, and size alone is not a suitable metric. The Enterprises' low-risk activities should be considered when analyzing our systemic risk.

    - **The stability capital buffer should be based on the Board of Governors of the Federal Reserve's "Method 1" G-SIB systemic risk scoring methodology.**

        - All five of Method 1's risk-based indicators should be applied. The results of the calculation would be skewed if cross-jurisdictional activity and complexity indicators were removed. Similar to banks, the Enterprises should receive appropriate credit under this relative analysis for our lower cross-jurisdictional activities and lesser complexity.

        - Consistent with the statutory capital requirements, participation certificate ("PC") debt should be excluded from the interconnectedness indicator.

        - The systemic risk attributes of both Enterprises should be included in the aggregate global indicator denominator.

- **The countercyclical capital buffer component should not be adopted.** The Proposal already incorporates sufficient countercyclical elements and conservatism. The U.S.

bank regulators have not deployed this tool, and the preferred approach has instead been to provide targeted relief from rules that may drive procyclical behavior.

5. Advanced Approach for Credit and Market Risk

- **We recommend that the advanced approach for credit and market risk not be adopted. The requirements of the Collins Floor and parallel risk-based capital analyses also weigh against adoption of the advanced approach.**

  - The Proposal incorporates significant risk sensitivity, particularly with regard to mortgage exposures that make up most of Freddie Mac's assets. The proposed standardized approach is based on the Enterprises' existing models, incorporates mark-to-market LTV ("MTMLTV") ratio requirements and is reinforced through rigorous annual stress testing. Therefore, to require the development of a second, separate model from the ones currently in use would likely incur significant time and resources without any clear benefit.

  - We recognize the value of improving internal models so that they may inform calibration of the standardized approach. Improvements in risk management techniques can be addressed as a supervisory matter rather than driven by a specific capital requirement.

6. Operational Risk Capital

- We support the use of a modeled, risk-based framework for operational risk, subject to certain considerations designed to provide additional flexibility. The final capital framework should:

  - **Permit a lower loss-confidence interval than 99.9% to reduce volatility in potential outcomes; and**

  - **Reduce the risk capital floor from 15 bps to 8 bps of ATA to ensure it is calibrated as a backstop to risk-sensitive measurement approaches rather than a binding floor.**

7. Compliance Period

- **The final capital framework should incorporate an appropriate phase-in period, beyond the effective date of any final rule, given the projections in the Proposal that the Enterprises would need to substantially increase our capital and provide acceptable returns in the form of distributions to investors.** The proposed deferral period and buffer concept is not sufficiently flexible and does not provide a pathway for compliance. We instead recommend a specific and transparent transition framework, including **a five-year transition period** for the regulatory minima and buffers, that is intended to permit the Enterprises to continue to pay dividends and attract investors, while achieving full capital compliance over time.

- **The final capital framework should clarify the timing of resumed PCA capital classifications for the Enterprises and the extent to which any classification-related restrictions on capital distributions or other actions would apply during any phase-in period while the Enterprises are raising capital.** Capital classification and potential enforcement actions have been suspended during conservatorship. In order to understand the interaction between FHFA's application of the statute and any transition period as described above, further clarity is needed on potential post-conservatorship intervention by FHFA.

In Sections II through VIII of these comments, as well as a set of Appendices, we make specific recommendations and provide additional explanation and analysis regarding elements of the Proposal in order to advance the guiding principles outlined above.

II. Risk-Based Capital Requirements

A. *In order to advance FHFA's goal of producing a risk-sensitive capital framework, the risk-weight floor for single-family and multifamily mortgages should be removed.*

The Proposal would impose a 15% floor on the risk weights of both single-family and multifamily mortgage exposures. FHFA supports its decision based on (i) review of financial-crisis-era losses, (ii) limitations in the models and analyses used to develop the standardized approach grids and multipliers and (iii) considerations related to exogenous risks, such as damage to physical property or climate change. We address each of these supporting arguments in our analyses below to demonstrate that the 15% floor is not necessary.

1. The varied risk profiles and lower loss history of the mortgage loans that would be subject to the floor dictate that the floor should not be applied.

When applied to the Enterprises' portfolio, the 15% floor would subject mortgage loans across a wide spectrum of historical loss rates to the same capital charge, undermining the risk sensitivity in the grid and multiplier framework. Furthermore, the floor almost exclusively would apply to loans with high FICO scores and low LTV ratios, thereby increasing the cost of acquiring and carrying these low-risk loans.

Appendix A.1 highlights actual, cumulative credit losses in the December 31, 2007 single-family portfolio as a percentage (in bps) of total UPB over the life of the loans.[16] The Appendix reflects the 2007 assets and their actual cumulative credit losses, adjusted to eliminate those loans with terms and attributes, as of December 31, 2007, that would cause them to be deemed non-QM, so as to align generally with our currently permissible products. The darker shaded cells represent those combinations of FICO scores and LTVs for single-family loans that would be subject to the 15% (or 120 bps[17]) floor. Using the observed loss rates as a

[16] On a post-mortgage-insurance ("post-MI") basis to align with the projections in the Proposal. Even on a pre-MI basis, the actual cumulative loss rates of low-risk loans in the adjusted 2007 portfolio would be a fraction of the floor.

[17] The conversion to bps is relative to an 8% total capital requirement.

proxy for an approximate risk weight, the Appendix highlights that the loss rates for these segments through the financial crisis were significantly lower than 120 bps. For example, cumulative loss history for the 2007 portfolio for mortgages with FICO scores of 720 or higher and LTVs of 60% or lower were between approximately 1 bp and 29 bps. In other words, all loans in this low-risk category experienced losses of less than one-quarter of the proposed floor, and a significant portion of those loans experienced single-digit basis point losses. Single-family QM in the 2007 portfolio with FICO scores of 740 or higher and LTVs of 70% or lower start at approximately 69 bps of cumulative loss—slightly more than half of the proposed floor—and fall considerably as FICO and LTVs improve.

This analysis shows that the floor impairs the risk sensitivity of the capital framework because of the material difference between a floor calibrated at 120 bps and the dispersion of loans that are subject to the floor across a wide range of observed risk significantly lower than 120 bps. Even without the adjustment to reflect our permissible product mix, the 2007 loan book demonstrates the same trend of lower loss rates as LTV decreases and FICO rises. Therefore, FHFA's concern with measurement risk in the standardized grids and multipliers is not borne out through observed losses of the mortgage loans subject to the floor. If there were significant measurement risk, one would likely see results inconsistent with expectations based on characteristics of the loans. To the contrary, the observed losses of a fraction of the floor in the segments with higher FICO/lower LTV attributes act as expected for loans with these characteristics and, therefore, validate the risk weights assigned by the standardized approach without a floor.

The elimination of risk differentiation caused by the floor would assign the same capital charge to a substantial portion of our portfolio. We estimate that the floor would have covered approximately 43% of our 2007 single-family portfolio UPB and would cover 62% of our Q3 2019 single-family portfolio UPB, in both cases adjusted to exclude non-QMs that are no longer permissible for purchase.[18] The broad swath of our portfolio that would effectively be subject to a static risk weight reinforces the point that, without modification, the Proposal may not achieve FHFA's aim "to preserve the mortgage risk-sensitive framework by avoiding a risk weight floor that was, in effect, the binding constraint for a substantial portion of single-family mortgage exposures."[19]

The floor is not necessary to address risks in the multifamily portfolio, given the significant conservatism embedded in the multifamily base risk weights. The Proposal would calibrate the lowest risk weight in the multifamily grids at 13%, meaning the most creditworthy borrowers and the loans least likely to experience loss or default would be subject to the floor of 15%. Using the observed loss rates as a proxy for an approximate risk weight, the loss rates for these segments through the financial crisis have been significantly lower than 120 bps. For example, the cumulative loss rates for the entire multifamily portfolio did not exceed 10 bps during the 2008-2010 period. Given that the base risk weights are quite high in comparison to our loss history, we believe that the 15% risk-weight floor is too high and is not suitably

[18] Both figures are also on a post-MI basis. The percentage of UPB on a pre-MI basis for each portfolio analysis would not be materially different. While we have a small number of legacy non-QM loans in the current portfolio, those exposures are negligible and have no effect on our arguments in favor of eliminating the floor.

[19] Proposal at 39,320.

calibrated to the capital required for both expected and unexpected losses in the multifamily portfolio.

2. The Proposal does not sufficiently account for Freddie Mac's current higher-quality balance sheet and product mix.

The Proposal's principal rationale for imposing the 15% floor is that, absent the floor, Freddie Mac's estimated single-family capital requirement during the financial crisis would have been less than our capital losses.

We have already shown above that large portions of our 2007 adjusted,[20] post-MI, single-family portfolio would have been subject to the floor, and therefore we believe misaligned with their actual risk as exhibited in actual cumulative loss rates of the portfolio. But that analysis also shows that the significant changes to our balance sheet have substantially mitigated the risks that existed before the financial crisis. The Proposal appropriately notes that a disproportionate share of crisis-era credit losses arose from types of single-family mortgage exposures that are no longer eligible for acquisition by the Enterprises.[21] Accordingly, the capital framework should account for those revised eligibility requirements by avoiding a high risk-weight floor.[22]

FHFA directed the Enterprises in 2013 to limit single-family acquisitions to mortgages that meet the requirements for a QM.[23] We are now prohibited from acquiring higher-risk mortgages, including those with (i) negative amortization, interest-only payments or balloon features; (ii) total points and fees exceeding 3% of the loan amount; (iii) a term exceeding 30 years; or (iv) little or no documentation required to verify income or other evidence of repayment ability.[24]

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[20] The adjustments made to the 2007 portfolio in the analysis were, consistent with the argument in this Subsection, to be able to measure the 2007 loss experience against the currently permissible loan products.

[21] Proposal at 39,319.

[22] Instead, the Proposal views the lower loss risk of the current portfolio as somehow leading to challenges in "allocat[ing] losses between borrower-related risk attributes and product-related risk attributes" and therefore "pos[ing] significant model risk." *Id.*

[23] Mortgages that meet the QM criteria are presumed to satisfy Section 129C of the Truth in Lending Act, as added and amended by the Dodd-Frank Act, requiring that creditors make a reasonable and good faith determination, based on verified and documented information, that a borrower has an ability to repay the loan. 15 U.S.C. § 1639c.

[24] *See* 12 C.F.R. § 1026.43(e) (defining "qualified mortgage"); Press Release, FHFA, FHFA Limiting Fannie Mae and Freddie Mac Loan Purchases to "Qualified Mortgages" (May 6, 2013), https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Limiting-Fannie-Mae-and-Freddie-MacLoan-Purchases-to-Qualified-Mortgages.aspx (generally restricting the Enterprises from acquiring mortgages that are not "qualified mortgages") ("QM Directive"); Freddie Mac, *Single-Family Seller/Servicer Guide* (Aug. 5, 2020) ("Seller/Servicer Guide"); *see also* 2018 Proposal at 33,327 ("A significant portion of the Enterprises' credit losses since 2007 resulted from higher risk loans which the Enterprises no longer purchase or guarantee due to the Ability to Repay and Qualified Mortgage rule issued by the [Consumer Financial Protection Bureau] in 2013 and due to the Enterprises' strengthened underwriting standards. Because the Enterprises no longer purchase these loans, FHFA

We have nearly eliminated our holdings of assets that were the primary drivers of crisis-era losses. Loans outside of Freddie Mac's current credit standards represented 35% of our 2007 portfolio UPB (and 69% of our financial crisis losses) compared to only 5% of our Q3 2019 portfolio UPB. Furthermore, prior to conservatorship, our investment portfolio included a significant amount of PLS that contained pools of mortgages that do not meet the QM criteria today (*e.g.*, no- or low-documentation loans and loans that may have fallen into a category characterized by the market as Alt-A). However, we no longer invest in PLS. As of June 2006, Freddie Mac had a PLS portfolio of $190.5 billion, which has declined by over 99% to $1.6 billion as of the third quarter of 2019.

In addition, cumulative comprehensive losses (plus dividend) over the 2008-2012 period for Freddie Mac, based on its actual portfolio during that period, (i) were estimated by FHFA at $98 billion[25] and (ii) would have been $49 billion without deferred tax asset adjustments. Excluding legacy securities decreases peak cumulative loss (plus dividends) to $24 billion, or the equivalent of 1.2% of UPB. Furthermore, peak cumulative comprehensive losses would be further reduced if one were to adjust for our current permitted product mix for single-family, the reduced size of our retained portfolio, our current level of guarantee fees and our current CRT structure. Our reduction in risk is also evidenced by diminishing losses over time in the DFAST severely adverse scenario between 2016-2019.[26] Accordingly, historical losses for these legacy loans and PLS portfolios should not be used to calibrate capital requirements or impose a floor on a going-forward basis.

While the calibration of the 2018 Proposal's credit risk capital requirements appropriately attributed a significant portion of the Enterprises' crisis-era losses to these products,[27] the Proposal does not. In addition, as noted in Subsection II.B of these comments, the grids and multipliers incorporate significant conservatism already (without application of the floor). Rather, the Proposal posits that a risk-weight floor is appropriate to mitigate risks associated with underlying historical losses that neither reflect our current permissible product mix, nor are likely to recur, taking into account FHFA's prudential oversight, our underwriting criteria and post-crisis legislative reforms.[28] Risk-based capital requirements should be calibrated based on activities that are permissible for the Enterprises today. That approach would result in capital requirements that cover stress-scenario losses, without the need to impose a floor that is not tailored to the post-financial-crisis business model of the Enterprises.

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also assessed whether the credit risk capital requirement under the proposed rule would have been sufficient to cover projected lifetime losses on loans that meet the Enterprises' current acquisition criteria.").

[25] Proposal at 39,283.

[26] *See* Appendix G.1.

[27] 2018 Proposal at 33,327-28 (analyzing the Enterprises' single-family portfolio in the fourth quarter of 2007 by "strip[ping] out the loans that would not be acquired today under [the Enterprises'] current acquisition criteria").

[28] *See* Proposal at 39,327; *see also* 15 U.S.C. § 1639c (preventing a creditor from making a residential mortgage loan unless the creditor makes a determination based on verified and documented information regarding the borrower's ability to repay the loan).

In addition to practically eliminating the legacy high-risk portfolios, both single-family and multifamily have materially improved underwriting practices.[29] In addition to FHFA's restriction on the Enterprises acquiring non-QM mortgages, we amended our underwriting standards to eliminate acquisition of loans with a debt-to-income ratio at origination greater than 50% and have set maximum LTV ratios for mortgages we currently acquire.[30] All such high-risk products (including non-QM) no longer purchased by Freddie Mac contributed to 69% of the losses in our 2007 portfolio.

For multifamily, underwriting standards and practices have dramatically improved since the 1970s and 1980s. For example, decisions are now required to be connected to a property's current rent roll and expenses and incorporate more conservative assumptions in pro forma analyses of property performance and rental growth expectations. Cash flow generated by the property has overtaken valuation as the primary factor in underwriting, embedding an additional layer of countercyclicality by reducing the impact of assumptions that prices may increase. Overall, these substantial improvements over time and the very low rate of default suggest the floor is inapt for multifamily exposures.

Concerns that the Enterprises may loosen underwriting standards[31] to acquire again high-risk loan products during periods of expanding economic growth and increasing homeownership are addressed by the supervisory and regulatory restrictions added since the financial crisis. Post-crisis improvements in risk management include: improved loss-mitigation capabilities (*e.g.*, streamlined workout options); more stringent oversight of mortgage insurance policies and capital; incorporation of automated tools into the underwriting process to verify the accuracy of data and compliance with our standards and detect loan manufacturing defects; tightened counterparty risk management; improvements in fraud prevention; and rolling out new products like Enhanced Relief Refi to support borrowers who need assistance. Since inception, CRT has been an additional source of discipline from the market in managing the credit risk of loans in both our single-family and multifamily portfolios. With each additional CRT transaction, the market receives information about our credit risk exposures that sophisticated participants (*e.g.*, underwriters, ratings agencies, reinsurers and investors) use to price risk.

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[29] In addition, FHFA's enforcement, on behalf of the Enterprises, of representations and warranties against originators who sold loans into the Enterprises' securitization pool, in the form of litigation, encourages tighter underwriting standards in the market and underwriting controls at Freddie Mac. *See, e.g.*, Press Release, FHFA, FHFA Sues 17 Firms to Recover Losses to Fannie Mae and Freddie Mac (Sept. 2, 2011), https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Sues-17-Firms-to-Recover-Losses-to-Fannie-Mae-and-Freddie-Mac.aspx.

[30] *See* Seller/Servicer Guide at Chapter 4203.4 (maximum LTV, total LTV and Home Equity Line of Credit total LTV ratios), Chapter 4301.5 (cash out refinances), Chapter 5103.1 (investor loans), Chapter 5401.2 (debt-to-income ratio). *See* Proposal at 39,289 (approvingly noting the Enterprises' tightened underwriting criteria that has led to significant de-risking). While the Seller/Service Guide is of course amended from time to time, any such amendments are subject to FHFA's prudential regulatory authority to ensure that we operate in a safe and sound manner. *See* 12 U.S.C. § 4513(a)(1)(B)(i).

[31] *See* Proposal at 39,294 ("The sizing of the regulatory capital requirements also must guard against potential future relaxation of underwriting standards and regulatory oversight over those underwriting standards.").

Capital requirements are not the only prudential tool available to FHFA. Notably, FHFA undertakes annual examinations of the Enterprises' financial safety and soundness and overall risk management practices and also uses ongoing monitoring, targeted examinations and risk assessments to achieve its comprehensive supervisory responsibilities.[32] FHFA also uses the robust CAMELSO rating system for the Enterprises, which takes into account capital, asset quality, management, earnings, liquidity, sensitivity to market risk and operational risk.[33] The Enterprises also are subject to DFAST stress test scenarios similar to those used in the banking industry.

Any remaining concerns with model risk and the risk-based capital approach[34] should be addressed through other, non-capital related elements of the post-conservatorship supervisory framework that provide FHFA with effective tools to shape the Enterprises' underwriting principles and standards.[35] The use of a loan-level floor that does not accurately reflect pricing of an asset and its associated capital is not the best method for addressing such concerns.

3. Setting the floor at 15% is unnecessary because other elements of the Proposal provide a sufficient backstop and are adequately countercyclical.

The floor is intended to operate as a backstop. FHFA suggests that the floor is necessary "to ensure the safety and soundness of each Enterprise and that each Enterprise is positioned to fulfill its statutory mission across the economic cycle, including during a period of financial stress."[36] We believe that these twin aims could be just as effectively served by incorporating appropriate risk-sensitive measures into the credit risk framework,[37] while

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[32] *See, e.g.*, FHFA, *Fannie Mae & Freddie Mac*, https://www.fhfa.gov/SupervisionRegulation/FannieMaeandFreddieMac (last visited Aug. 8, 2020) (describing examination and reporting framework for the Enterprises); FHFA, *Multifamily Mortgage Underwriting and Acquisitions* (Dec. 2014), https://www.fhfa.gov/SupervisionRegulation/ExaminerResources/Documents/Multifamily%20Mortgage%20Underwriting%20and%20Acquisitions%20-%20Final%20Version%201%200.pdf (containing information and procedures intended for the examination of the Enterprises with respect to risks related to developing underwriting standards and monitoring underwriting functions for multifamily loans).

[33] FHFA, *CAMELSO*, https://www.fhfa.gov/SupervisionRegulation/ExaminerResources/Pages/CAMELSO.aspx (last visited Aug. 8, 2020).

[34] The Proposal does not specify how FHFA plans to update the credit risk grids and multipliers over time. However, concerns about the potential for development of a slight skew over time prior to supervisory recalibration should not be addressed through a floor that undermines the risk-sensitivity of the grids and multipliers for a large majority of our portfolio.

[35] *See, e.g.*, FHFA, QM Directive; FHFA, *Multifamily Mortgage Underwriting and Acquisitions* (Dec. 2014), https://www.fhfa.gov/SupervisionRegulation/ExaminerResources/Documents/Multifamily%20Mortgage%20Underwriting%20and%20Acquisitions%20-%20Final%20Version%201%200.pdf.

[36] Proposal at 39,319.

[37] As indicated in Subsection II.B, we generally agree that the grids and multipliers proposed by FHFA offer an appropriately risk-sensitive analysis that can only be hindered by a floor.

permitting the Proposal's other backstop provisions and countercyclical elements to operate in place of a 15% floor.

The calibration of the credit risk capital grids for single-family already incorporates conservative assumptions and introduces floors—even low MTMLTV and high FICO scores are floored by the base risk weight assigned to the last band in the grids, and no band starts at zero. The grids factor in a stress scenario of a 25% drop in house prices. In addition, there is already an explicit loan-level countercyclical adjustment to the MTMLTV for single-family exposures that further increases the implicit drop in house prices when prices are well above long-term trends (and we would support adding an adjustment for multifamily, as discussed in Subsection II.C.2). Layering a non-risk-based floor on top of the stress-scenario loss and countercyclical adjustments already incorporated into the grids does not, we believe, reflect the actual risks in the Enterprises' mortgage pools.

In addition, since the Proposal already includes the leverage capital requirements and the PCCBA (based on ATA), Freddie Mac considers the floor duplicative. As discussed elsewhere in these comments, we strongly support incorporating these elements into the capital framework with appropriate adjustments. The experiences of U.S. banking organizations (and those in other countries) have generally shown them, when appropriately calibrated, to be effective tools that are complementary to the standardized approach to credit risk. In addition to the stress already factored into the grids and multipliers, the introduction of stress-scenario losses directly into the capital requirements, through the PCCBA stress-scenario loss component, should address FHFA's concern with financial crisis-era losses and should be sufficient to counteract any measurement risk. Furthermore, the leverage ratio (with appropriate adjustments) would also provide a floor across all of the Enterprises' assets. Given the monoline nature of the Enterprises, almost all of our exposures are mortgage-related. Therefore, the leverage ratio and the PCCBA (based on ATA and not RWA) already accomplish a key supervisory aim of the 15% floor by creating general floors for all mortgage exposures in a stress period (assuming the stress capital component is revised, as we have suggested, to be linked to stress testing results). In light of these requirements, Freddie Mac believes that a 15% RWA floor is not necessary to achieve safety and soundness, to address model concerns or to address broad systemic risk concerns.

4. <u>The 15% floor could engender adverse selection in our portfolio by leading originators of lower-risk mortgages to find better execution in private markets, which would affect pricing across our business lines.</u>

By reducing the risk sensitivity of the capital framework, the floor could increase the costs of acquiring low-risk mortgages because such mortgages would be subject to a higher capital charge notwithstanding their limited credit risk. Approximately 30% of new single-family acquisitions would be affected by the floor, which could require us to set higher guarantee fees for these acquisitions in order to address the capital increase. We estimate that the Proposal overall would result in an increase of 11-15 bps (2-3 bps attributable solely to the proposed floors) for guarantee fees for single-family mortgages. An increase of 15-35 bps might be required to address the additional capital necessary across our entire single-family portfolio because new acquisitions take several years to become a meaningful share of our portfolio overall.

Loans to creditworthy borrowers may be more likely to remain on-balance sheet at originating financial institutions than to be sold to the Enterprises because acquisition costs for private market actors would generally be more commensurate with those borrowers' low risk of delinquency and default. By preventing us from incorporating appropriate risk differentials in pricing purchases and guarantees, the floor could skew the risk and pricing against the safest and best-performing segment of our portfolio.

In addition to increasing guarantee fees, these effects may induce the Enterprises to increase holdings of higher-risk assets to provide acceptable returns on equity with the same balance sheet.[38] More specifically, the floor creates incentives to reduce participation in, or increase costs for, lower-risk businesses. Pricing offered by the Enterprises across this segment of credit profiles also would trend toward the uneconomical compared to other market participants and otherwise would make the Enterprises less competitive in these lowest risk sectors of the market. However, we fulfill our mission by broadly supporting the full range of mortgages that meet our underwriting and credit requirements. Diversification of credit profiles and geographic and market attributes is not only core to our mandate, but also is demanded by investors, improves the overall risk profiles of the Enterprises and reduces concentration of certain risks in the Enterprises. In addition, as noted in Subsection I.E.2 above, a reduction of volume in the low-risk segment may require higher pricing across other segments of our portfolio, including loans to support affordable housing. Such loans could find a cheaper outlet with government-insured programs, further constraining our earnings and participation in the affordable segment of the market.

5. A 15% floor is not necessary to address tail risks that are a small part of our credit losses and are adequately addressed by the conservatism of the grids and multipliers framework.

We agree that certain risks, such as flooding, earthquakes, terrorism and war, should be reflected in our capital requirements. While home prices and homeownership are primarily driven by broader U.S. economic performance, the materialization of such risks may have negative macro-economic effects that could affect our balance sheet and may lead to loan-level credit defaults. The Enterprises' geographically diversified footprint across the United States reduces concentration risk associated with exposures to loans in disaster-prone regions. Even if FHFA were to determine that these risks should be subject to a separate credit risk capital charge, historical experience demonstrates that losses tied to tail events have been small overall and that a blunt floor-based mitigant is not suitable, particularly at the level proposed and in light of the possible consequences to loan pricing.

In addition, as shown above, the floor increases capital required for low-risk mortgages. Borrowers with significantly varying creditworthiness are equally susceptible to risks stemming from physical events, as those events are not concentrated only among the low-risk mortgages subject to the floor. Therefore, the floor is not a suitable tool for addressing those risks, as its implementation would imply that risks to the physical collateral should be

[38] *See* Subsection I.E.2.

charged only when the mortgage exhibits a high FICO score or a low LTV such that it is subject to the floor.

B. *We generally support the risk weights and haircuts assigned in the look-up tables, but the grids and risk multipliers should be adjusted in a few targeted ways to better match the risks posed by particular assets.*

We agree with the proposed approach to determining risk weights. In addition, we agree with the significant granularity of the risk-weight determinations, given the business model of the Enterprises. We recommend, however, that the single-family and multifamily grids and multipliers be enhanced in a few key ways.

1. The single-family look-up tables should be modified to split the 30-60% LTV band into three bands.

The Proposal would require a two-dimensional risk weight grid to determine base risk weights before subsequently applying risk multipliers. We agree that the primary risk factors, and therefore determinants of required capital, for loans across our single-family book are credit score and MTMLTV (after implementing the countercyclical adjustment). We recommend that FHFA finalize as proposed the general framework to link base risk weights for the single-family portfolio to these two factors, subject to the enhancements we note below.

As proposed, the look-up tables would use bands that are designed to differentiate between the credit risk of loans, based on blended credit score and adjusted MTMLTV. The Proposal would calibrate the bands for adjusted MTMLTV at below 30%, 30-60%, 60-70%, and then increasing in five or 10% increments thereafter.[39] We recommend FHFA modify the 30-60% adjusted MTMLTV band. Without modification, this band would cover 44% of our single-family UPB and not differentiate among assets based on MTMLTV. There is significant observed risk distribution across the loans in this band because actual loss for the Q4 2007 QM portfolio ranged from 10 bps to 72 bps within this band, as shown in Appendix B.1. Splitting this range into three bands for 30-40%, 40-50% and 50-60% MTMLTV would align the risk sensitivity of these bands with the other bands in the look-up tables. This modification would make the capital framework more risk sensitive overall by increasing differentiation across the credit and collateral spectrum.

2. The single-family look-up tables should be modified to eliminate the proposed refinance burnout multipliers.

Aside from the two primary risk factors of credit score and MTMLTV, the Proposal would establish multipliers for various secondary risk factors. One of these risk factors is cohort burnout, which reflects the potential effect of the number of refinance opportunities on loans in our portfolio. The Proposal would establish multipliers of 1.2, 1.3 or 1.4 based on whether the burnout rate is low, medium or high. Therefore, the Proposal would effectively

[39] Proposal at 39,378-79.

impose a significant capital charge for loans in our portfolio that have not refinanced (or prepaid) during periods of refinance opportunities.

We recommend that the cohort/refinance burnout multipliers be eliminated. Interest rates have steadily declined since 2007, meaning our recorded loss history already incorporates perceived credit risk from cohort burnout. The grids and multipliers were developed by FHFA based on loss history of loans during the financial crisis.[40] Applying a multiplier would be duplicative. Moreover, our portfolio generally experiences loss rates for loans that do not refinance during periods of interest rate declines that are significantly lower than the 20-40% additional charge reflected in the multipliers. The data demonstrate that cohort burnout does not present additional credit risk, beyond what is already accounted for in the base risk weights.

The multiplier implies that lack of prepayment in a falling rate environment increases risk of loss, but in our experience, borrowers have different propensities to prepay based on a variety of factors across all credit profiles in our portfolio. In addition, the cohort burnout multiplier would increase capital for loans that do not refinance, without providing an offsetting capital benefit for loans that do refinance. These loans that come back into our portfolio are lower risk, as exhibited by their approval for a new loan, which should offset any assumed credit risk posed by loans that did not refinance (and are therefore deemed subject to cohort burnout). However, the opposite is true under the grids because newly refinanced loans do not receive the benefit of a seasoned loan. Newly refinanced loans have higher capital charges than loans that were paid off due to lack of seasoning and a refinance multiplier. Moreover, loans that do not refinance tend to have lower balances, which is a characteristic of affordable loans. The proposed multiplier generally would apply to a higher proportion of affordable loans, which have a lower propensity to prepay than other loans in our portfolio. Increasing required capital for these loans may cause pricing for them also to increase, which has implications for our mission and strategic objectives described in Subsection I.E.2. Finally, we note that a multiplier would be procyclical because falling interest rates during stress periods create opportunities to refinance.

3. Single-family loans that are in delinquency due to a COVID-19-related forbearance should not be treated as non-performing loans ("NPLs").

The Proposal solicits comment on whether a delinquency associated with a COVID-19-related forbearance should cause a single-family mortgage exposure to become an NPL.[41] We recommend that FHFA not adopt this approach. Congress provided financial institutions with the option to suspend any determination of a loan modified due to COVID-19 as being a troubled debt restructuring.[42] The U.S. banking agencies have provided guidance that loans modified pursuant to the CARES Act will not result in the loans being considered

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40 *See* Proposal at 39,303.

41 Proposal, at 39,307.

42 Coronavirus Aid, Relief, and Economic Security Act of 2020 ("CARES Act"), Pub. L. No. 116-136, § 4013(b), 134 Stat. 281, 480 (2020).

restructured or modified for purposes of risk-based capital.[43] Congress' intent and the purpose behind relief provided to U.S. banking organizations applies with equal force to loans acquired by the Enterprises. If an originator would not need to treat a loan as non-performing due to a COVID-19-related forbearance, then the risk weight applied by the Enterprises should also reflect this determination. This risk determination should be unaffected by a sale to an Enterprise.

In addition, Congress determined that financial institutions should not face capital constraints due to accommodating borrowers whose creditworthiness may be impaired by the current exogenous economic shock stemming from a public health crisis. FHFA has similarly recognized the importance of ensuring housing market liquidity through the pandemic by permitting the Enterprises to purchase single-family mortgages in forbearance that meet specific eligibility criteria.[44] FHFA has determined that preserving the Enterprises' ability to stand ready to purchase mortgages will allow originators to keep lending. Treating these loans as NPLs would impair FHFA's policy objective and our mission to support the secondary mortgage market by making it more expensive for us to acquire them. Applying the proposed NPL grid to loans purchased by the Enterprises would also impair the effectiveness of the CARES Act and relief for U.S. banking organizations by potentially deterring new originations of conforming loans. This result, in turn, may hinder the shared government and industry effort to support the housing market through the pandemic.

4. The multifamily look-up tables should be modified by reducing the variance between base risk weights for fixed and adjustable rate mortgages.

While we agree that capital charges for multifamily adjustable-rate mortgages ("multifamily ARMs") should be slightly higher to account for increased payments in a rising rate environment, the underlying credit risk is the same regardless of the interest rate type. Credit risk should be the primary driver of the calibration of the multifamily grids, as it is for single-family.

The persistent declining interest rate environment has created more demand for floating-rate loans. Given the proposed grid's punitive treatment of floating over fixed, the Proposal would result in an increase in our capital requirements in excess of the underlying credit risk. For example, applying the base risk weights would result in average risk-based capital requirements of 9-10% for an average floating-rate loan versus 6% for an average fixed-rate loan.[45] This result is not calibrated to the credit risk posed by our multifamily

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[43] Federal Reserve, Federal Deposit Insurance Corporation ("FDIC"), National Credit Union Administration, Office of the Comptroller of the Currency ("OCC"), Consumer Financial Protection Bureau, *Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus (Revised)* (Apr. 7, 2020), at 4.

[44] Press Release, FHFA Announces that Enterprises will Purchase Qualified Loans in Forbearance to Keep Lending Flowing (Apr. 22, 2020), https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-that-Enterprises-will-Purchase-Qualified-Loans.aspx.

[45] This example is based on a loan with a 75% MTMLTV, for which the base capital grids would apply approximately the same capital treatment to a multifamily fixed-rate loan with a 1.3x debt service coverage ratio

floating-rate loans, which present the same credit risk profiles as our multifamily fixed-rate loans. This result also does not reflect our prohibition on borrowers receiving larger loans with a floating rate than with a fixed rate, which removes one of the ordinary indicators of credit risk for floating-rate loans.[46] We recommend that FHFA retain the current look-up table, but place multifamily ARM loans into a lower DSCR band when interest rates are falling.[47] Appendix B.2 demonstrates the risk-based capital by quarter for examples of floating- and fixed-rate loans under the Proposal and our proposed approach. This approach would reduce the disparity in capital treatment for multifamily ARMs in periods when the yield curve is inverted or flat, which would make the capital framework more dynamic and risk-sensitive overall by promoting comparable treatment of comparable credit risks.

5. The multifamily look-up tables should be modified by applying a 0.60 risk multiplier to multifamily properties that are funded through LIHTC.

The multifamily base risk weights are also subject to multipliers based on secondary risk factors.[48] We recommend that FHFA add a 0.60 multiplier for exposures to multifamily properties that are funded through LIHTCs, which are the main source of new affordable rental housing construction in the United States. These loans tend to perform particularly well due to strong commitment from local governments and housing authorities to the acquisition, rehabilitation, or new construction of rental housing targeted to lower-income households. Governments encourage the use of the LIHTC program to fund these projects. Appendix B.3 demonstrates the low LIHTC delinquency rates as compared to non-LIHTC multifamily loans.

Foreclosure history also warrants a 0.60 multiplier. According to Freddie Mac historical data, only two LIHTC loans out of more than 3,000 have gone to foreclosure since 2008, which is a cumulative foreclosure rate of less than 0.07%. Third-party studies have also indicated extremely low levels of cumulative foreclosure rates for LIHTC loans of approximately 0.35% from 1991 to 2005[49] and 0.65% from 2000 to 2008.[50]

C. *We note the countercyclical adjustment proposed for single-family MTMLTV adds to the conservative assumptions incorporated into the standardized approach*

("DSCR") and a multifamily floating-rate loan with a 1.47x DSCR, but significantly increase the capital on a floating rate loan with a 1.3x DSCR.

[46] While the eligible property types, terms, pricing, and other features of floating- versus fixed-rate products differ, the loan amounts for both products are both generally set at $5 million to $100 million.

[47] Specifically, if the ratio of a 10-year swap divided by 3-month Libor (or the equivalent Treasury/SOFR rates) is 1.5x or below (indicating falling interest rates), then a multifamily ARM loan should be subject to a risk weighting two bands below the base risk weight. If the ratio is above 1.5x, then the base risk weight should apply.

[48] Proposal at 39,389.

[49] Ernst & Young, *Understanding the Dynamics IV: Housing Tax Credit investment Performance* (June 2007), at 49.

[50] CohnReznick, *Housing Tax Credit Investments: Investment and Operational Performance* (Nov. 18, 2019), at 44.

grids and multipliers. We recommend that FHFA also include a countercyclical adjustment for multifamily exposures.

Before commenting on the countercyclical adjustments generally, we note that Freddie Mac adopted CECL as of January 1, 2020. CECL ensures that estimated credit losses more closely align loss estimates with current and expected future economic conditions than the previous "incurred loss" methodology that was backward-looking and focused on already-impaired loans. Instead, CECL is a forward-looking measure that includes expected lifetime losses. Determining these expected losses and provisioning consistent with CECL will require increases in allowances for loan losses as soon as we foresee times of economic stress and volatility and, therefore, in a more timely fashion as economic forecasts deteriorate. Overall, CECL will increase reserves for estimated stress-scenario losses through a down economic cycle.

1. The single-family countercyclical adjustment addresses a substantial portion of the procyclicality observed in the 2018 Proposal, but the single-family grids also already contain a significant amount of conservatism.

The Proposal embeds conservative countercyclical assumptions in calibrating the base risk weights for single-family exposures, even before the application of a countercyclical adjustment. First, FHFA notes that the grids are already generally benchmarked to a 25% decline in home prices based on housing market trends over time.[51] Second, as depicted in Appendix C.1, layering the MTMLTV countercyclical adjustment on the "base" assumption of a 25% decline in home prices would effectively require the Enterprises to determine base capital requirements, assuming a 36% decline in home prices from the 2007 peak. This implies a substantial shock beyond the 19% drop experienced during the prior financial crisis.[52] This combination of adjustment and conservative base grids also causes us to assume an additional 13% house price drop at the trough (such as in 2012). We acknowledge that predicting the bottom of a down credit cycle is difficult (if not impossible), and therefore the countercyclical adjustment should require capitalizing to a worse level than the worst-loss historical scenario. Nevertheless, the actual experienced house price decline over the period depicted in the Appendix was 19% from the peak, and (with perfect hindsight) 0% at the trough.

Also, it appears that the grids have not incorporated benefits from our (and industry-wide) changed underwriting standards. The portfolio contains significantly less risk than the "look back" to financial crisis-era losses may imply. In fact, post-2009 vintage originations are performing substantially better than expected and better when compared to older vintage loans that exhibit the same risk attributes and home price growth or decline. We attribute these lower loss experiences to enhanced Freddie Mac standards and quality control and improvements in underwriting across the industry. These improvements also serve to counteract any model risk concerns in the grids and multipliers.

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[51] *See* Proposal at 39,303.

[52] At the peak, the combined effect of the countercyclical adjustment and the price decline incorporated into the grids would cause us to capitalize for the prior appreciation of house prices above the long-term trend as well as for a future expected decline as home prices increase above the trend.

While we are in favor of the countercyclical elements of the single-family adjustment and the credit risk grids, we respectfully request that FHFA consider the conservative assumptions and adjustments already incorporated into the base risk weights and in our loss reserve accounting as it evaluates our comments on the additional layers of conservativism in the Proposal (including, but not limited to, the 15% risk-weight floor, the leverage capital requirements, the PCCBA and the CRT benefit calibration).

2. Multifamily exposures should also be subject to their own countercyclical adjustment, calibrated using U.S. long-term vacancy rates.

FHFA requested comment on potential approaches, if any, to a multifamily countercyclical adjustment.[53] We recommend the creation of a multifamily countercyclical adjustment. The adjustment should be designed to maintain financial system confidence and support the mortgage markets during a downturn without distorting economic risk.

We agree with FHFA that, unlike the single-family portfolio, an analysis based on deviation from home price trends is not suitable for multifamily because there is a lack of sufficient data from which to develop a reliable long-term trend in multifamily property values.[54] We suggest that a multifamily countercyclical adjustment be designed using long-term vacancy rates, based on their negative correlation with multifamily home pricing. This metric is a key indicator of operating performance, and there is a publicly available government-published index with vacancy data that could be used to calibrate the capital framework.

We recommend the adjustment be applied when realized long-term vacancy rates fall outside a prescribed band of 6-9%. When vacancy rates are below the band (*i.e.*, market conditions are better than normal), DSCRs would be reduced and MTMLTVs would be increased, and when vacancy rates are above the band (*i.e.*, market conditions are worse than normal), DSCRs would be increased and MTMLTVs would be reduced. In either direction, 25% of the total adjustment amount would be applied to the DSCR, while 75% of the total adjustment amount would be applied to the MTMLTV. When vacancy rates are within the 6-9% band, then the base risk weights in the Proposal would apply. As shown in Appendix C.2, this band is set based on historical negative correlation of vacancy rates with the inflation-adjusted multifamily commercial property price index. The Appendix also shows the effect of our proposed alternative on a hypothetical loan. A countercyclical adjustment that is calibrated in this manner would address the potential volatility of our multifamily capital requirements, which in turn would improve our capital planning process and ability to properly manage risk in our portfolio. As FHFA has suggested in the Proposal, this adjustment would also reduce procyclicality of the multifamily credit risk capital framework because LTVs and DSCRs for multifamily loans become stressed as property values decline.[55]

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[53] Proposal at 39,324.

[54] *Id.*

[55] *Id.* In addition, as discussed above, the calibration of the countercyclical adjustment should recognize the protection against housing price swings and collateral values provided by the forward-looking analyses under CECL.

D. *The 20% risk weight for commingled and crossholdings of Enterprises' MBS should not be adopted because the activities do not increase systemic or taxpayer risks, as each Enterprise would already be capitalized for its stand-alone credit risk.*

The Proposal would generally assign a 20% risk weight to the exposure of one Enterprise to the other.[56] The 2018 Proposal, by contrast, would have assigned a 0% credit risk capital requirement for an MBS guaranteed by the other Enterprise. We recommend that FHFA not adopt the proposed risk weight and instead adopt the 2018 Proposal's approach.

As described below, an Enterprise can either resecuritize or purchase the other Enterprise's MBS.

First, each Enterprise resecuritizes securities that meet a common set of standards and have similar attributes (*i.e.*, UMBS or Level 1 PC debt) for the purpose of repackaging into, and issuing, Level 2 and Level 3 securities. Level 2 and 3 securities are commingled resecuritizations of UMBS that may consist of Freddie Mac wrapping its guarantee on (i) collateral issued solely by either Freddie Mac or Fannie Mae or (ii) a mix of Freddie Mac and Fannie Mae issued collateral (*i.e.*, Supers, REMICs and re-REMICs) ("commingled securities"). The common attributes of UMBS and Level 1 securities that are acquired for commingling have been developed over the years through a rigorous, public and analytical process that has been accepted by the market.

Second, each Enterprise purchases UMBS as an investor ("cross-holdings"), in order to provide liquidity to the secondary housing market. The Enterprises purchase UMBS in the TBA market as conditions warrant, and may not know until 48 hours prior to the settlement date whether the underlying collateral for the security that is ultimately acquired would be Fannie Mae-issued, Freddie Mac-issued or a mix.

The development of UMBS, resecuritization and TBA products is premised on the Enterprises issuing securities that are fungible and on eliminating any incentives for an Enterprise to favor its own collateral over the other's.

1. The 20% risk weight for commingled securities is not necessary because other elements of the capital framework address credit risk of the underlying collateral.

A counterparty credit risk weight of 20% for the Enterprises would increase capital beyond the Enterprises' total combined credit risk, by layering additional capital on top of each Enterprise's full capitalization under the Proposal whenever each holds or guarantees securities of the other. Each Enterprise is already capitalized for the risk exposures of its guarantees and its asset holdings under the same capital regime.

[56] Proposal at 39,338. Equity exposures and acquired CRT exposures would not be subject to this risk weight.

This potential layering of capital would be magnified through resecuritizations, even though resecuritizations do not add any risk to the overall system. For example, suppose that neither Enterprise held any securities issued by the other and the Enterprises' combined risk-based capital requirement was $100 billion under the capital framework once finalized. If the Enterprises were to maximize holdings or guarantees of each other's securities, that aggregate capital requirement would exceed $100 billion—perhaps substantially—even though there is no additional risk in the financial system or the secondary housing market. If each Enterprise is appropriately capitalized in relation to its risks and exposures, there should be no need for the Enterprises to re-capitalize for each other.

The resulting higher capital costs would be borne in part by investors in the form of higher guarantee fees and lower return on UMBS. Ultimately, home buyers would face higher borrowing rates from a flow-through of higher guarantee and resecuritization fees.

2. The 20% risk weight for commingled securities could pose challenges for maintaining the common securitization platform and cause a return to a segregated market.

A guiding principle of the capital framework should be to advance FHFA's goal of improving liquidity and fungibility in the TBA market. FHFA has stated that:

> The TBA market is an important contributor to a strong, vibrant, and highly liquid secondary mortgage market, which benefits lenders, investors, and borrowers. The TBA market serves to make more capital available for mortgage lending, enables broad lender participation, and reduces costs throughout the housing finance system. In fact, TBA market liquidity can also translate to important borrower benefits in the form of lower mortgage rates, more efficient lending processes, lower transaction costs, and the ability to "lock in" the interest rate on a mortgage prior to closing on the loan.[57]

Throughout conservatorship, FHFA has created incentives for the Enterprises to hold each other's MBS. At the encouragement of FHFA, Freddie Mac lowered our resecuritization fees for UMBS in order to produce fungibility off the single security platform, and because a portion of each resecuritization is a commingling containing an embedded guarantee from Fannie Mae. FHFA has determined that fungibility, commingling and cross-holdings are necessary not only to achieve these goals for the TBA market, but also for the Enterprises to fulfill our charter obligations to support the secondary mortgage market. FHFA has stated that "successful adoption of the UMBS will enhance liquidity, efficiency, and competition in the TBA-eligible MBS market."[58] It is well-settled that combining the separate markets for each Enterprise's MBS into one increases the liquidity and depth of the market for

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[57] FHFA, *An Update on Implementation of the Single Security and the Common Securitization Platform* (July 2016), at 1, https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Implementation-of-the-SS-and-the-CSP_772016.pdf.

[58] Uniform Mortgage-Backed Security, 83 Fed. Reg. 46,889, 46,892 (Sept. 17, 2018).

Freddie Mac and Fannie Mae TBA-eligible MBS. These benefits have flowed through to a wide variety of stakeholders.[59]

The proposed 20% risk weight would negatively affect the portfolio commingling and cross-holdings that help support the UMBS market and would encourage the market to distinguish between Enterprise issuances. Each Enterprise would be required to choose whether to stipulate delivery of its own UMBS[60] (and pay a related fee) or provision excess capital to account for the risk of receiving the other Enterprise's MBS (whether in a TBA trade or a REMIC). Either choice would be akin to a capital risk charge that would diminish UMBS market fungibility and liquidity. FHFA seeks to ensure "general alignment" between characteristics of each Enterprise's TBA-eligible securities, meaning the cash flows should be "sufficiently similar as to not induce UMBS investors to make stipulated trades."[61] The 20% risk weight makes achieving this goal challenging, given that the Enterprises are among the largest investors in this market. Commingling also would be diminished, if not eliminated, due to the requirements for stipulations and the costs resulting from Enterprise orders for UMBS that depart from general market practice.

The proposed 20% risk weight on Enterprise holdings also would disincentivize the Enterprises from issuing UMBS in the first place. In particular, Freddie Mac modified its issuance structure to conform to Fannie Mae's as a necessary condition to developing the single security platform. However, market liquidity and the Enterprises' ability to take advantage of investor appetite for restructured risks would be curtailed if each Enterprise incurs a further charge for resecuritizing the other's securities (even though the UMBS were designed to be fungible). In other words, these nascent markets can thrive only if there is no distinction between Freddie Mac and Fannie Mae collateral, which a 20% risk weight would draw. Assigning this risk weight would be akin to charging us a fee to include Fannie Mae-issued collateral in our Supers, REMICs and re-REMICs. In turn, this would disincentivize us from issuing Level 2 and Level 3 securities incorporating Fannie Mae securities, would create incentives to resort to single-issuer resecuritizations and therefore would undermine the goal of issuing a uniform security.

In addition, UMBS already in the market would be affected. The Enterprises are the largest participants in the market, and they would be dissuaded by the 20% risk weight from

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59 *Id.*

60 As described above, the Enterprises also purchase UMBS to support liquidity in the secondary housing market. Investing in each other's securities is a core part of the Enterprises' charter obligations and missions. The 20% risk weight would apply to these investments, disincentivizing additional liquidity in the market. For example, in the TBA market, the purchasing Enterprise may not know the issuer of the underlying collateral until 48 hours prior to the trade date. Under the single security platform, a purchaser is supposed to be indifferent. That feature is designed to foster fungibility and provide for a wide and deep TBA market, but the Proposal would nullify those benefits by introducing substantial costs for the Enterprises to provide this liquidity. In order to avoid receiving a security subject to the capital charge, each Enterprise could add a stipulation to a TBA trade that blocks receipt of the other's securities. We suspect that the market would likely see this more often in the Enterprises' TBA transactions, thus risking a return to a segregated market for the Enterprises' securities issuances.

61 Uniform Mortgage-Backed Security, 83 Fed. Reg. 46,889, 46,891 (Sept. 17, 2018); *see also id.* at 46,890 (noting that one commenter on the UMBS proposed rule argued that an increase in stipulated trades "could detract from liquidity in the TBA market").

purchasing UMBS issued by the other, either for investment or commingling purposes. UMBS trading in the market could be devalued, thereby undermining confidence in the single security initiative. Furthermore, the UMBS in the market would retroactively charge each Enterprise to the extent that already-issued guarantees incur higher capital requirements. Each Enterprise would be incentivized to avoid purchasing the other Enterprise's UMBS, to sell UMBS issued by the other Enterprise, and potentially to redeem an Enterprise's own UMBS.

These costs would disproportionately affect Freddie Mac over Fannie Mae because Freddie Mac Level 2 and Level 3 securities contain a significantly higher proportion of Fannie Mae-issued UMBS than the proportion of Freddie Mac-issued UMBS in Fannie Mae Level 2 and Level 3 securities. This difference is due to Fannie Mae's larger share of the TBA-eligible market.[62] Assigning a risk weight for commingled collateral would result in disparate pricing between the Enterprises, as this segment of our business would instantly become significantly more expensive to operate (and more expensive relative to Fannie Mae), despite presenting no incremental credit risk. This impact on pricing would undermine the single security initiative's core premise of fungibility without achieving a measurable risk objective.

The imposition of a 20% risk weight therefore risks prompting a return to a segregated market. The advent of the UMBS has started to remove historical inefficiencies created by differences in the Enterprises' MBS and has improved liquidity in the secondary mortgage market.[63] A uniform, common Enterprise MBS has facilitated liquidity by allowing further commingling of collateral issued by each Enterprise and the creation of guaranteed securities backed in whole or in part by securities of the other. Between June 2019 and June 2020, approximately $381 billion of Enterprise-issued re-securitizations (Level 2 and Level 3 securities), supported in part by commingling, were issued to the market. The commingled exposures would be subject to the proposed 20% risk weight, when they are not currently subject to any such charge. The imposition of a charge would likely reverse the early incentives to treat Freddie Mac and Fannie Mae UMBS as fully fungible. That would restore advantages that Fannie Mae had derived from its larger outstanding supply of TBA-eligible collateral, resulting in increased fees for our investors and a likely reduction in the demand for our securities. To compensate for these developments, we would need to provide incentives for investors to purchase our securities that we expect would reduce our profitability. We believe that such a result could complicate achieving an orderly exit from conservatorship and make it more difficult to provide the same liquidity, pricing and issuance between the Enterprises.[64]

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62 As shown in Appendix D.1, there are 3.5 times more Fannie Mae UMBS in the market than Freddie Mac UMBS as of June 2020. Approximately 81% of the UPB underlying Freddie Mac Leve1 2 securities are wrapped by Fannie Mae; approximately 32% of the UPB underling Freddie Mac Level 3 securities are wrapped by Fannie Mae.

63 *See* Laurie Goodman and Jim Parrott, Urban Institute, *A Progress Report on Fannie Mae and Freddie Mac's Move to a Single Security* (Aug. 2018), at 5 and Figure 2, https://www.urban.org/sites/default/files/publication/98872/single_security_0.pdf.

64 We note that, even if the risk weight were zero, to the extent that a leverage ratio is binding, a guarantee on a commingled security would incur a capital charge for the amount of the other Enterprise's securities that are being guaranteed, potentially generating the same negative consequences described above.

3. The Enterprises' counterparty risk does not resemble the counterparty risk posed by exposures that the Proposal describes as comparable under the Basel framework and U.S. bank capital framework.

FHFA has calibrated the 20% risk weight for cross-holdings of each Enterprise's securities by reference to debt exposures that it views as similar under the Basel framework. The Proposal notes that the Basel framework assigns a 20% risk weight to exposures to sovereigns and central banks rated A+ to A- and claims on banks and corporates with ratings AAA to AA-.[65] The U.S. bank capital framework applies a 20% risk weight to exposures to the Enterprises, other than equity exposures to preferred stock, which are subject to higher risk weights.[66] Notably, exposures to the U.S. government, its central bank or a U.S. government agency that is directly and unconditionally guaranteed by the U.S. government receive a risk weight of zero under each of the relevant capital frameworks.

We disagree that obligations of an Enterprise should be treated as akin to A+ to A- governments or to a band of potentially AA- corporates. The markets for securities issued by the Enterprises are deep and liquid. The standardization of these products and the predictable issuance schedules have long made them attractive to investors. Obligations of the Enterprises bear a closer resemblance to obligations of the U.S. government than to the issuers that FHFA references as similar. The U.S. housing market closely tracks U.S. economic performance, and the Enterprises would continue to benefit from economies of scale due to our overall size and the influence of our underwriting standards on the market.

4. Existing regulatory and supervisory oversight of the Enterprises, along with our simple business models, obviate the need for a substantial counterparty risk weight for commingling and cross-holdings.

The Enterprises are also subject to a degree of prudential regulation that is materially more stringent than in the run-up to the financial crisis, which has substantially reduced the risk of failure. Furthermore, given the monoline nature of the Enterprises, our overlapping seller and servicer standards, and the similarity in the risks we take to underlying borrowers, the 20% risk weight overstates each Enterprise's limited counterparty risk exposure to the other. Each Enterprise would have capitalized, under the proposed capital framework, its various exposures to mortgage debt, and therefore exposure to the other's guarantee is implicitly backed by the other's robust capital. In addition, not only would the Enterprises be highly capitalized for the mortgage risks we each take, but the underlying risks are also largely passed through to investors through PC debt and CRT. As discussed above, these forms of capitalization would already support the UMBS collateral underlying Level 2 and Level 3 securities, which provides adequate protection for credit risk without layering an additional capital charge when that collateral is re-securitized.

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65 *See* Proposal at 39,288.

66 12 C.F.R. § 217.32(c).

E. *We agree that certain of the Enterprises' assets should be subject to a market risk capital requirement. We recommend further tailoring of the market risk charge to ensure focus on those exposures that exhibit risks of market volatility.*

We agree with the Proposal's definition of spread risk,[67] as well as the proposed requirement that exposures with more than *de minimis* spread risk be subject to market and credit risk capital charges.[68] We recommend that FHFA clarify that the business strategy related to, and the accounting treatment of, an exposure may support a determination as to whether spread risk is *de minimis*. This clarification would permit the Enterprises to determine whether the appropriate risk to be capitalized is credit risk, or if market risk is an additional significant driver of risk and therefore also should be capitalized.

In connection with securitization or sale activities, we hold certain loans that are classified as held for sale, for which mark-to-market ("MTM") changes in fair value immediately affect earnings and capital. We also hold certain securities in our retained portfolio that are classified either as available for sale or trading assets under U.S. GAAP, for which changes in MTM immediately affect earnings. The risk profiles of these positions may expose us to immediate losses in earnings and capital due to changes in the bid or offer price of such positions relative to a risk-free or funding benchmark and thus have greater than *de minimis* spread risk. While securities accounted for as "trading" should be subject to the market risk capital requirement, the underlying mortgages and original guarantee are exposures under the credit risk framework. Freddie Mac has both credit and market risk exposure in relation to retained or re-purchased loans and securities. This potential for double-counting should be recognized, and the underlying mortgage risk should remain capitalized under the credit risk framework.

As part of our investment activities, we hold other positions as investments with holding periods spanning the life of the positions, and we account for these investments under an amortized cost approach. These assets are principally designed to support our guarantee businesses while earning net interest margin. Although these positions may be sold, for example, in support of our obligation to buy non-performing loans or provide liquidity to secondary markets, we believe this would result in *de minimis* spread risk impact to Freddie Mac's capital base for several reasons. First, if these positions were sold prior to maturity, unrealized losses due to changes in market value resulting from spread risk would be realized over the life of the positions, and not immediately recognized in the income statement. Second, the positions that are sold in support of providing secondary market liquidity are generally replaced as we buy similar loans on or about the same time as the security sale, thus maintaining the portfolio size and net interest margin at similar levels. Third, these assets would not be liquidated frequently, and if needed for liquidity purposes, they would be used for collateralized borrowing instead. According to the Proposal and the principles we have described above, these positions should pose *de minimis* risk of loss resulting from a change in the bid or offer price relative to a risk free or funding benchmark. Finally, we note that not imposing a market risk

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[67] Proposal at 39,404 (defining "spread risk" as "the risk of loss on a position that could result from a change in the bid or offer price of such position relative to a risk free or funding benchmark, including when due to a change in perceptions of performance or liquidity of the position.").

[68] *Id.* (defining "covered position" as "any asset that has more than *de minimis* spread risk (other than any intangible asset, such as any servicing asset)").

capital charge on these positions would result in greater alignment with the U.S. bank capital framework, which imposes only a credit risk capital charge and no market risk capital charge to similar positions.

III. CRT Benefits

In addition to transferring interest rate and liquidity risk to third-party investors through securitization activities, we have developed CRT programs that broadly distribute mortgage credit risk to third-party investors.[69] These transactions have transformed our business model from one where we buy and hold credit risk to one where we buy and transfer a majority of such credit risk. Overall, these offerings have resulted in a substantial increase in protection for our single-family credit guarantee and multifamily mortgage portfolios, attracted new and varied investors and additional private capital to the housing market, and reduced the risk of losses to taxpayers and to us if borrowers go into default. Treasury, FHFA and the Enterprises have realized substantial benefits from CRT as a direct reduction of our risk exposure, including a reduction of Enterprise risk concentration and a greater ability to manage volatility through credit cycles. As discussed further below, these benefits improve the safety and soundness of the Enterprises by reducing the volatility of our earnings and provide greater transparency to the market regarding our credit risk, which in turn permits the market to act as an additional check on our risk management. These benefits should be preserved and encouraged. In addition, the final capital framework should maintain sufficient flexibility to reduce credit risk capital through risk mitigation, as we believe that would allow for faster capitalization of the Enterprises and accelerate the exit from conservatorship.

Several elements of the Proposal, however, would operate as practical disincentives to further development and expansion of CRT programs. There are at least three elements of the proposed framework that could significantly diminish the benefits achieved by the CRT programs. First, calibrating the leverage ratio as the binding constraint under the proposed framework reduces or provides no capital benefit to CRT. Second, the Proposal would apply a 10% floor on the ability of CRT to reduce aggregate risk weights of a pool. Third, the Proposal would apply 10% haircuts on any offset achieved by CRT sales to third-party investors. Imposing these requirements would misalign risk management incentives and distort the market for these transactions, developed in concert with FHFA's Conservatorship Capital Framework ("CCF"), which recognizes CRT benefits by *reducing* capital required for credit risk as CRT credit protection increases. Our comments are intended to reduce these disincentives and support a risk-sensitive measure for CRT capital benefits.

A. *The capital framework should recognize the risk-reducing nature of CRT and the historical policy support for the development of the CRT program.*

Across the economic cycle, CRT has delivered significant earnings and capital benefits. Integrating CRT into Freddie Mac's business model makes capital easier and cheaper

[69] We define "CRT transactions" as those arrangements where we actively transfer the credit risk exposure on mortgages that we own or guarantee. We define "other credit enhancements" as those arrangements, such as traditional loan-level and upfront primary mortgage insurance, where we do not actively take part in the transfer of the credit risk exposure. We take part in some seller-based loan-level risk transfers.

to raise by reducing the amount of capital required to support our credit risk and by having CRT investors cover portions of our credit risk. The capital framework should make the tangible benefits of CRT transparent to Freddie Mac and our capital providers.

As indicated elsewhere in these comments, the bank capital framework should be modified and tailored to both the risks and risk mitigants that set the Enterprises apart from banks. CRT represents a major difference between the business practices of the Enterprises and banks. Whereas the Enterprises pass through a significant proportion of stress-scenario credit risk to the market, banks generally retain a much greater proportion of the credit risk of assets that they hold in their portfolios. Banks generally do not engage in CRT of the same type, and certainly not to the same extent, as the Enterprises.[70] This difference derives from the Enterprises' status as monoline institutions that seek to pass through (indeed, specialize in passing through) most risks (whether liquidity, interest rate or credit) to investors. Passing through risks makes it possible to simultaneously execute our mission and operate in a safe and sound manner. While banks are subject to safety and soundness standards, they are not subject to the same constraints on asset mix and scope of activities or the same mission to increase the liquidity and stability of the secondary mortgage market. These differences between Enterprise and bank business models and business purposes should be reflected in commensurate, forward-looking adjustments to the bank capital framework that account for the full integration of CRT into the Enterprises' business models. As CRT continues to grow in volume and coverage, the Enterprises' risk profiles will become even less like the risk profiles of banks.

Stakeholders have acknowledged the benefits and effectiveness of CRT in reducing credit risk and concentration risk posed by the Enterprises' Congressionally-mandated role to support the secondary mortgage market. Passing credit risk through to investors complements the Enterprises' traditional role of passing through interest rate risk, in both cases to investors who seek different types of exposure to the housing market with varying yields and varying risks. With many years of experience, the data indicate that CRT has been a successful and cost-effective way to mitigate the credit risk of the Enterprises' mortgage guarantees. For the single-family portfolio, through July 2020, Freddie Mac has conducted 137 CRT transactions, transferring a substantial majority of its estimated stress-scenario credit losses in cumulative risk-in-force CRT issuance of $61 billion on $1.6 trillion of UPB.[71] FHFA has set increasing goals for the portion of single-family UPB subject to CRT, and currently requires 90% of targeted UPB to be covered by CRT.[72] The Enterprises have consistently exceeded these increasing targets, with the exception of 2019, when the Enterprises were only slightly below target.[73] As a matter of course, the Enterprises—with encouragement from FHFA—now transfer

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[70] *See* Laurie Goodman, Urban Institute, *Credit Risk Transfer: A Fork in the Road* (June 2018), at 15, https://www.urban.org/sites/default/files/publication/98578/credit_risk_transfer_a_fork_in_the_road_0.pdf.

[71] Freddie Mac has also conducted 24 reperforming loan securitizations transferring a substantial majority of its estimated stress-scenario credit losses in $5 billion in first loss and mezzanine tranches sold on $36 billion of UPB as of the end of July 2020.

[72] FHFA CRT Report, at 3.

[73] *Id.*

credit risk on most new single-family acquisitions where those transfers are economically feasible.

The relative figures for multifamily are even higher, and multifamily CRT transactions have been just as successful at mitigating credit risk in a cost-effective way. For the multifamily portfolio, through June 2020, Freddie Mac has conducted 427 CRT transactions, transferring its estimated stress-scenario credit losses in cumulative risk-in-force CRT issuance of $51 billion on $399 billion of UPB. Of that total issuance, 99.9% of K-Deal loans are current by outstanding principal balance, and we have not realized any credit losses on our K-Deal guarantees.[74] We currently target transferring 87% of the credit risk on new acquisitions via multifamily CRT transactions,[75] and we have exceeded this target.[76] As a matter of course, the Enterprises—with encouragement from FHFA—now transfer credit risk on most new multifamily acquisitions where those transfers are economically feasible.

Selling credit risk to diverse sets of private investors and insurers disperses that risk throughout the market. This substantially reduces the concentration of mortgage credit risk in the Enterprises and has placed them on a more stable footing to exit conservatorship. The current approach uses a mix of capital markets transactions and insurance transactions. This approach has been deliberately designed to increase and diversify the Enterprises' number of counterparties, which further reduces concentration risk. More than 250 investors have participated in Freddie Mac's CRT transactions for single-family and more than 700 for multifamily.[77] That investor base is distributed across large asset managers, hedge funds, reinsurers and other market participants, including real estate investment trusts, sovereign wealth funds, insurance companies and banks. The presence of many smaller and low-leverage investors with different risk-return appetites has been identified as a stability-enhancing feature of the CRT market and has contributed to the depth and liquidity for Structured Agency Credit Risk securities and K-Deals.[78] Because each bond issuance is usually in the hundreds of millions of dollars, such transactions are by nature dispersed to a large segment of the private market.[79] The greater the number of CRT transactions, the greater the diversification and increased coverage of expected losses arising from our aggregate UPB.

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[74] Freddie Mac, *K-Deal Performance* (June 2020), at 3, https://mf.freddiemac.com/docs/k_deal_performance_presentation.pdf. There has been approximately $19 million in total losses realized by B-piece investors, representing less than 1 bp of total issuance.

[75] Freddie Mac, *Multifamily Securitization Overview* (as of March 31, 2020), at 27, https://mf.freddiemac.com/docs/mf_securitization_investor-presentation.pdf.

[76] FHFA CRT Report at 1, 9 (reporting that we transferred a portion of credit risk on 91%, or $68 billion, of 2018 multifamily new acquisitions).

[77] Freddie Mac, *K-Deal Program* (as of December 31, 2019), https://mf.freddiemac.com/docs/k-deal-handout.pdf (multifamily); Freddie Mac, *About CRT* (as of March 31, 2020), https://crt.freddiemac.com/about-crt.aspx (single-family).

[78] David Finkelstein, Andreas Strzodka, and James Vickery, *Credit Risk Transfer and De Facto GSE Reform*, Federal Reserve Bank of New York Economic Policy Review 24, No. 3 (2018), at 101, https://www.newyorkfed.org/medialibrary/media/research/epr/2018/epr_2018_credit-risk_finkelstein.pdf.

[79] Don Layton, *Demystifying GSE Credit Risk Transfer* 12-13 (Joint Center for Housing Studies, Working Paper, 2020), https://www.jchs.harvard.edu/sites/default/files/harvard_jchs_gse_crt_part2_layton_2020.pdf.

This investor base is also sophisticated, which is another source of risk reduction for CRT. Investors evaluate transactions and manage portfolio exposures in the routine course of business, using data analytics and financial models in combination with macro-economic views to assess and price mortgage credit risk. These relationships help address concerns around capital adequacy in a number of important ways. The transparency (*e.g.*, data reporting, changes to business practices) required to interact with sophisticated investors and the feedback loop of investor insights brings discipline to the management of credit policy and loss mitigation, helping to limit the potential for increased demands on available capital. CRT transactions consist of a number of non-guaranteed credit tranches sold to third parties—from "junior" tranches that cover losses of relatively higher probability to "mezzanine" tranches that cover credit losses with a more remote chance of occurring. The Enterprises use market pricing of these different tranches to benchmark our own probability assessment of various potential credit loss levels and improve our credit risk measurement and internal capital measures.

As growing amounts of the Enterprises' guarantee-business-related credit risk have been passed through to market investors through CRT, capital required for credit risk under the CCF has been reduced by approximately 77% for single-family[80] and 90% for multifamily. But the Proposal would represent a departure from this approach and would reduce incentives to continue to engage in CRT. The proposed capital framework would lead the Enterprises to execute fewer CRT transactions and therefore increase our retained credit risk.

Treasury and FHFA have generally viewed CRT as a success for both single-family and multifamily, and our recommendations regarding CRT are in line with this view. For example, FHFA is focused on introducing private capital into the housing finance system to lessen taxpayer risk and has stated that this priority includes "having the Enterprises conduct credit risk transfers for our single-family credit guarantee business," which have become "core parts of the Enterprises' business model" and have, to date, "attracted private capital to share in credit losses."[81] Treasury has similarly noted that the Enterprises' CRT programs "enhance taxpayer protection and foster price discovery and market discipline."[82] As such, Treasury has recently recommended that FHFA's capital rule "provide for appropriate capital relief" for the Enterprises to transfer credit risk through a diverse mix of CRT mechanisms that are approved by FHFA.[83] However, the Proposal would reduce current capital relief by an estimated 46% (from $21.5 billion to $11.6 billion).[84]

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80 Freddie Mac, Quarterly Report on Form 10-Q, for quarter ended June 30, 2020, at 42 tbl. 23.

81 FHFA, Strategic Plan: *Fiscal Years 2018-2022* (Jan. 29, 2018), at 12, https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/StratPlan_Final_1292018.pdf. FHFA also pledged to work with the Enterprises to "continue to enhance these programs." *Id.*

82 Treasury, *Housing Reform Plan* (Sept. 2019), at 30, https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf.

83 *Id.*; *see also Oversight of the Treasury Department's and Federal Reserve's Pandemic Response Before the H. Comm. on Fin. Services*, 116th Cong. (2020) (testimony of Steven T. Mnuchin, U.S. Sec'y of the Treasury) ("I agree that they should receive relief, that we should encourage them to do credit risk transfers with creditworthy counterparties.").

84 *See* Proposal, at Tables 26 and 29.

Despite the coordinated efforts promoting CRT, FHFA expresses several concerns in the Proposal about CRT instruments, including that CRT will not perform as expected due to complex structures and other legal risks[85] and that CRT instruments do not have loss-absorbing capacity.[86] The proposed risk-weight floor and the haircut are intended to address those concerns. Neither of these broad concerns is borne out by our years of experience with CRT, and each concern would be adequately mitigated by our recommendations and proposed revisions. As discussed in depth below, our recommendations are intended to better align the proposed capital framework for the Enterprises with Treasury's recommendations and FHFA's support for and encouragement of CRT. That alignment suggests the removal or modification of several elements of the proposed framework that create significant disincentives to our CRT efforts.

B. *The treatment of CRT should be made more risk-based by (i) replacing the 10% risk-weight floor with a risk-based approach and (ii) eliminating the blanket 10% haircut on CRT tranches held by third parties in favor of a more targeted approach.*

Our recommended modifications would ameliorate the Proposal's potentially negative effects on the Enterprises' CRT programs and would better assist FHFA in achieving its supervisory aims.

First, we believe that the 10% risk-weight floor is not necessary because many retained tranches are senior enough that they should not suffer losses even in stress scenarios. Tail risk can be sufficiently addressed through risk-based capital requirements that properly calibrate risks, rather than a floor. CRT products are also designed to properly allocate risks across the tranches, which is an additional risk-management tool. The floor acts as the primary disincentive to engaging in CRT transactions and should be removed.

Second, we believe that the 10% haircut on the benefit received from transferring credit risk to third-party investors or protection providers serves only to layer disincentives and significantly decrease the risk sensitivity of the Proposal's treatment of CRT. CRT transactions are often either cash transactions (sale of tranched securities) or collateralized by cash. In transactions where credit risk may not be fully collateralized, those counterparties must be financially strong, post collateral for a portion of their exposure and be prepared to meet commitments in adverse market conditions.[87]

The treatment of CRT generally should be capital neutral. The Proposal would depart from this principle.[88] We recommend that FHFA treat CRT exposures such that the sum of capital required for each CRT tranche is equivalent to what would be required for the

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85 Proposal at 39,330 ("One of the lessons of the 2008 financial crisis is that securitization structures, especially complex securitizations, might not perform as expected . . . Similarly, there might be unique legal risks posed by the contractual terms of CRT structures and by the practices associated with contractual enforcement.").

86 Proposal at 39,332 ("CRT transactions do not provide the same protection as regulatory capital.").

87 Proposal at 39,329.

88 Proposal at 39,331.

underlying portions of collateral exposure covered by the CRT transaction. FHFA justifies its deviation from capital neutrality based on concerns with model risk and because the structure of CRT instruments may be complicated. However, our proposed alternative, described in detail below, would address both of these concerns. Tying capital relief to stress-scenario losses can mitigate model risk, given the years of data and experience that we now have with these transactions. Concerns with complexity are mitigated because we have conducted over 500 CRT transactions with hundreds of conservative counterparties, and the market has a substantial amount of information regarding these structures. Moreover, FHFA retains supervisory authority and prudential oversight for all of our activities, including CRT, and may address both of these concerns through the ordinary supervisory process, rather than a prescribed capital floor.

Several of the reasons why the proposed risk-weight floor is unsuitable for single-family and multifamily mortgage exposures are also applicable to the proposed floor and haircut in the CRT approach. First, as with the 15% floor for risk weights for mortgage exposures, the 10% floor for CRT impairs the risk sensitivity of the capital framework because it does not permit any risk differentiation, nor possibility of obtaining further risk-mitigation benefit, below the floor. Second, the 10% floor and 10% haircut are unnecessary because other elements of the Proposal provide a sufficient backstop to guard against potential losses from CRT transactions.[89] The CRT approach would be layered on top of the PCCBA and the leverage capital requirements. The purpose of these backstop provisions is to mitigate the exact type of risks that the Proposal states are posed by CRT, namely model risk and measurement error that may cause performance in a stress scenario to become untethered from historical loss experience.[90] The leverage ratio would already operate as floor to the risk-based requirements across our entire portfolio. The PCCBA would provide a sufficient buffer to remain well-capitalized in a stress scenario. Adding the retained risk floor as well as decreasing the benefit of CRT through the haircuts reduces further the risk sensitivity of the proposed framework and dampens (contrary to stated policy) the benefits of the CRT program.

The various issues that FHFA has identified with CRT—from limited resemblance to equity capital; to model, operational and market risk; to risks that contractual terms may be difficult to enforce in a stress scenario; to counterparty risk—are addressed through other elements of the Proposal. For example, ability to manage risk through the creation of diverse pools allows us to attract protection sellers who generally provide cash up front, in the form of the purchase price or collateral, that may be used before a loss to equity. Diversification should be a factor in favor of granting capital relief. While it is true that we must continue to service CRT obligations in stress scenarios (in contrast to equity capital instruments) obligations on CRT diminish in stress scenarios as interest due on the outstanding protection balance would also fall in such an environment. Furthermore, the proposed operational risk charge would also cover our CRT activities, while the broader buffers and leverage ratio are backstops that are designed to ensure we can meet our obligations during stress periods. It is therefore unnecessary to impose specific floors and haircuts on CRT instruments.

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89 *See* Section II.

90 *See* Proposal at 39,281.

Our two recommendations, described below, would encourage the purchase of more protection through higher CRT coverage levels, lock in the gains under our CRT program that have begun to place the Enterprises on a sustainable path to exit conservatorship and continue to foster the development of a diverse array of CRT tools consistent with FHFA's and Treasury's longstanding and long-term goals for the Enterprises.

1. The 10% risk-weight floor should be replaced with a 25% increase in the detachment level necessary to achieve full stress-scenario loss protection.

The Proposal compares CRT to equity and expresses concerns that CRT may amplify model risk. We agree that certain structured CRT can create idiosyncratic risk where the performance of the underlying loans have variance. However, this variance is mitigated through diversification of the underlying assets, and it is addressed adequately by other elements of the Proposal, including the calibration of the base risk weights and sizing the PCCBA, as discussed in Section II and V.

For both single-family and multifamily, we recommend the detachment point[91] be increased to 125% of CCF Stress[92] in order to obtain 100% capital relief. The increased detachment would create a buffer to guard against perceived model risk and idiosyncratic risk and would incentivize higher levels of CRT coverage by giving capital benefit above stress-scenario loss. Encouraging higher protection levels would alleviate perceived model risk when actual losses are higher than predicted and the level of losses exceeds CCF Stress. By contrast, the proposed floor is a static measure and may, in practice, *disincentivize* purchasing additional credit protection.

Uncertainties in the benefit of a particular CRT transaction would be better addressed by a haircut to the capital benefit in the area around the CCF Stress. Our proposed formulae, a walk-through of how the formulae would work and information about the capital benefit in the 25% intervals around CCF Stress are set forth in Appendix E.1. The impact of our proposed approach on an example of a DNA deal is described in Appendix E.2. Calibrating bands using the intervals described in the Appendix would allow a risk-based determination by Freddie Mac to seek greater protection (rather than being floored at 10%) if it negotiated a detachment point higher than expected stress-scenario losses. Based on our analyses, we believe that variance around the stress-scenario loss expectation is less than 25%, and therefore 25% is a sufficiently conservative interval. Furthermore, this proposal is more conservative than the current CCF for both single-family and multifamily. By providing for capital relief at levels above stress-scenario loss, this alternative would incentivize the purchase of additional coverage for the purposes of mitigating idiosyncratic CRT risks. Additional protection benefits taxpayers as well as capital investors.

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91 Parameter *D* in the proposed credit risk transfer approach. *See* Proposal at 39,394 (defining "Parameter *D*" as "the detachment point for the exposure, which represents the threshold at which credit losses of principal allocated to the exposure would result in a total loss of principal.").

92 Capital required in relation to the attachment point plus expected losses (*i.e.*, K_A+EL).

2. The 10% haircut on CRT third-party tranches should not be adopted. Instead, we recommend FHFA adopt a process for applying an OEA adjustment.

The 10% haircut on all sold CRT tranches (the OEA) should not generally apply to all CRT transactions. It is a "one size fits all" punitive adjustment that does not take into account the differences among CRT structures and their risk mitigation benefits. Ultimately, it would discourage the Enterprises from engaging in CRT.

For both single-family and multifamily CRT transactions, idiosyncratic risks are already significantly mitigated through the feedback loop in the primary and secondary markets as transaction volume increases and markets acquire additional data about these structures. Furthermore, as stated in the Proposal,[93] FHFA concluded that deal features and triggers effectively mitigated prepayment and delinquency stresses. Additionally, FHFA concluded that the OEA is not applicable to mortgage insurance coverage or other contracts such as hazard insurance, which contain highly complex coverage rules and claims processes, but have sufficient historical evidence of effectiveness.

The multifamily business model is built to protect against structural idiosyncrasies, including pool diversification considerations (such as geography, loan size and loan balance), in high-stress economic environments. Our multifamily segment accomplishes this goal through excess subordination structures, meaning that it sells risk up to subordination levels well beyond stress-scenario losses in any particular CRT transaction. Therefore, for multifamily, our proposed alternative approach to hold 25% additional subordination beyond stress-scenario loss levels would generally align with existing practice, which experience to date indicates has been an effective credit risk mitigant.

In our view, idiosyncratic effectiveness risks for both single-family and multifamily would be addressed through the capital benefit haircut around the stress-scenario loss plus or minus the 25% interval described above. Accordingly, an additional OEA is not necessary.

Outstanding transactions, as well as deal structures and sizes that are similar to outstanding transactions, should not require OEA. If OEA is necessary for a particular transaction that may have higher idiosyncratic or complexity risks than existing structures or deal sizes in use by Freddie Mac, we recommend the following supervisory process: (i) an Enterprise would be required to provide notification to FHFA only of material changes to a particular CRT transaction type or of a new CRT transaction that is materially different from existing transactions; and (ii) the Enterprise would work with FHFA to determine whether OEA may be necessary based on those material changes from existing structures. Given that FHFA has examined our existing CRT structures, we believe that, going forward, this supervisory process for OEA should be effective from FHFA's perspective.

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93 *See* Proposal at 39,335.

IV. Leverage Ratio Requirements

A. *The Proposal's leverage capital requirements should be revised to ensure that fixed measures such as the leverage ratio are ordinarily not binding constraints. Instead risk-based measures should govern in most economic scenarios.*

The Proposal would require the Enterprises to satisfy two leverage ratio requirements: (i) core capital of at least 2.5% of ATA and (ii) Tier 1 capital of at least 2.5% of ATA.[94] The Enterprises would also be subject to a requirement to maintain a buffer (the prescribed leverage buffer amount ("PLBA")) of Tier 1 capital of at least 1.5% of ATA in order to avoid restrictions on distributions and discretionary executive compensation.[95] The Tier-1-based leverage requirements therefore total to 4.0% of ATA. As the Proposal notes, the primary purpose of the leverage requirements is to "serve as a credible backstop to the risk-based capital requirements."[96]

We agree that leverage requirements should be a backstop to risk-based requirements. A backstop, by definition, means that the leverage requirements should not become the routine (or even frequent) binding capital constraint. Our recommendation to revise the leverage ratio proposal is consistent with our theme throughout these comments that the primary determinants of capital should be risk-based. The leverage ratio levels we propose would, based on our analyses, allow the leverage ratio to serve its function as a backstop "floor," rather than as the predominantly binding determinant.

Our review of the Proposal's leverage requirements modeled on the U.S. banking capital framework's SLR requirements, with on- and off-balance sheet items captured equally in the ATA denominator, led to the conclusion that the proposed requirements would not function as a backstop. Both historically and looking forward over a stress-testing period, the proposed leverage requirements were frequently binding and in contexts in which, in Freddie Mac's view, they should not be. In many scenarios, Freddie Mac believes the binding leverage ratio would undermine FHFA's efforts to develop a significantly risk-sensitive capital framework, as the non-risk-based and fixed nature of the leverage ratios would act as the determinant of the Enterprises' capital.

For example, as shown in Appendix F.1, looking back over the past 18 years, Freddie Mac estimates that the proposed leverage requirements would have been binding for Freddie Mac in all but two or three years at the peak and end of the previous financial crisis.[97] Looking forward, the leverage measurement would also be the binding constraint on Tier 1 capital in every quarter of a nine-quarter stress horizon under a severely adverse stress scenario, as seen in Appendix F.2. Consequently, as currently calibrated, the proposed leverage ratio requirements would not fulfill FHFA's stated goal of serving as a credible backstop. Instead, the

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94 Proposal at 39,293.

95 *Id.* at 39,301.

96 *Id.* at 39,289-90.

97 Measured against the Proposal's Tier 1 risk-based capital requirement and adjusted in each year for credit products currently permissible for our portfolio.

leverage requirements would act procyclically by requiring more capital than Freddie Mac believes the risk of the portfolio would dictate in scenarios when it should not, such as a going-forward stress scenario.

B. *The Proposal's leverage capital requirements should be revisited in light of the unique business models of the Enterprises and long-standing statutory and interpretive precedent that recognizes the special nature of the Enterprises. We recommend adoption of the bifurcated construct from the Safety and Soundness Act with a minimum Tier 1 (in contrast to core) capital ratio to on-balance-sheet "held" assets of 4.00% and a minimum Tier 1 capital ratio to the UPB of guaranteed assets of 1.50%.*

We analyzed and explored recalibrating the SLR-like proposed leverage and PLBA ratios. But merely shifting the ratios lower, based on certain relative risk principles, proved that it is not only the *level* of the proposed leverage requirements, but the *model* upon which the Proposal is based, that is causing their frequently binding nature. Importing the bank leverage capital framework, including the all-encompassing ATA base, is not suitable for the unique business model of the Enterprises.

The business model of the Enterprises is already reflected in the Safety and Soundness Act and the statute's capital requirements. The bank capital framework, whether based on a fixed amount of Tier 1 capital across RWA or across ATA, does not appear to be the best-suited approach for the risks presented by the Enterprises' assets, as it is primarily based on credit quality. However, as FHFA recognized in the 2018 Proposal, the unique nature of the Enterprises lies in our lower-risk, match-funded liability structure. Therefore, under 12 U.S.C. § 4612, the minimum capital requirements for the Enterprises establish a key and necessary dichotomy between, on the one hand, those assets that an Enterprise holds and funds via short or long-term debt or equity capital ("held" assets), and on the other hand, those assets that an Enterprise transfers and funds in full through long-term guaranteed debt issued to third parties ("transferred" or "passed-through" assets). More specifically, held assets require core capital of 2.50%, and transferred assets require core capital of 0.45% of the UPB or the amount of the off-balance sheet obligation.[98]

This differentiation between held and transferred assets is not only the statutory model for capital for the Enterprises, but it also is reflective of the non-complex operations and business model of the Enterprises. Congress recognized that business model when designing a capital framework in 1992. Since then, the Safety and Soundness Act's framework has been validated as appropriate for the Enterprises. The Housing and Economic Recovery Act of 2008 retained this basic capital structure.[99] In the 2018 Proposal, FHFA summarized the appropriateness of the application of this "bifurcated" model to the Enterprises based on the "differentiat[ion] between the greater funding risks of the Enterprises' non-trust assets and the

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[98] 12 U.S.C. §§ 4612(a), 4614(a)(1)(B). In this Section of our comments, we adopt the conceptual framework stated by Representative Leach in 1991 between assets "held" and those transferred or "passed through," rather than an on- or off-balance-sheet framework. 137 Cong. Rec. H6833 (daily ed. Sept. 25, 1991) (statement of Rep. Jim Leach) ("Rep. Leach Statement").

[99] Pub. L. No. 110-289, 122 Stat. 2654 (2008) ("HERA").

minimal funding risks of the Enterprises' trust assets, while also providing a backstop that is anchored to the proposed risk-based capital framework itself."[100]

Therefore, we urge FHFA to consider the unique model of the Enterprises and the long-standing design and application of the Safety and Soundness Act's capital framework, in order to permit the overall regulatory capital framework to be appropriately risk-based and not determined by a fixed leverage ratio. Notably, FHFA acknowledged the special business make-up of the Enterprises when designing the single-family and multifamily credit risk grids and multipliers for mortgage exposure, as these incorporate much more granular and dynamic elements than the bank capital framework so as to differentiate among the Enterprises' primary assets. The leverage ratio should also be crafted differently from the bank capital framework to account for the unique Enterprise model.

We understand that there has been a history of questions concerning whether the levels of capital required by the Safety and Soundness Act are adequate.[101] We agree that the levels are too low,[102] but believe that the bifurcated approach to the leverage element of capital, as a backstop to a robust risk-based capital model, is the best-suited design overall for the Enterprises' distinct business and risks. Our recommendation is similar to an alternative included by FHFA in the 2018 Proposal with a few modifications: Tier 1 (in contrast to core) capital should constitute 4.00% of on-balance-sheet "held" assets[103] and 1.50% of the UPB of guaranteed "passed-through" assets.[104,105] The Enterprises were supportive of the bifurcated alternative in 2018,[106] and Freddie Mac has patterned our recommendation on that FHFA alternative.

Freddie Mac acknowledges that it would still be subject to the statutory minimum core capital requirements. We are recommending a replacement for both the revised core capital

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100 2018 Proposal at 33,383.

101 *See, e.g.*, 2018 Proposal at 33,384 (FHFA "believes that both of the statutory leverage minimums are much too low to be safe and sound, [but] the concept of different ratios for different aspects of the Enterprises' business could be implemented at higher levels as proposed under the bifurcated alternative").

102 The statute provides FHFA adequate authority to increase the minimum requirements. 12 U.S.C. § 4612(c). The statute also provides adequate authority to establish these increased requirements as a leverage ratio, and separately establish risk-based capital requirements, as set forth in the Proposal. 12 U.S.C. § 4611(a)(1).

103 Increased from the statutory adequate capitalization core capital ratio of 2.50%. 12 U.S.C. §§ 4612(a)(1), 4614(a)(1)(B).

104 Increased from the statutory adequate capitalization core capital ratio of 0.45%. 12 U.S.C. §§ 4612(a)(1), 4612(a)(2), 4614(a)(1)(B).

We propose using definitions of "trust" assets and "non-trust" assets that are consistent with those proposed in the 2018 Proposal. *See* 2018 Proposal at 33,326 and 33,391-2.

105 We have included in these comments various recommendations to modify certain of the proposed risk-based requirements. We believe that FHFA should calibrate the leverage ratio after determining final risk-based requirements. Without such a review and recalibration, there is the risk that the leverage ratio would act as a binding constraint under too many economic scenarios, rather than as a backstop.

106 *See* Letter from Jorge Reis, SVP, Enterprise Capital, Liquidity and Market Risk, Freddie Mac, to Alfred Pollard, General Counsel, FHFA (Nov. 16, 2018); Letter from Celeste Brown, EVP and CFO, Fannie Mae, to Alfred Pollard, General Counsel, FHFA (Nov. 15, 2018).

requirement in the Proposal (*i.e.*, 2.50% of ATA) and the "supplemental"[107] leverage ratio in the Proposal (*i.e.*, 2.50% Tier 1-to-ATA ratio with a PLBA of an additional 1.50%). Our recommendation would (i) use Tier 1 capital as the numerator and (ii) increase the minimum Tier 1 ratio for each of held assets and passed-through assets. The use of Tier 1 capital in the numerator is more conservative than the 2018 Proposal, which was based on a ratio with core capital in the numerator. In addition, both recommended ratios are a material increase over the statutory adequacy requirement. These conservative modifications together should support the conclusion that our recommended leverage ratios form a credible backstop to the risk-based requirements. It is also worth noting that the held assets would include various safe and liquid assets, such as cash, cash equivalents (such as U.S. Treasuries) and centrally cleared repurchase/reverse repurchase transactions on each, even though we believe that there are a number of reasons to exclude these assets from the denominator of the leverage ratios.

C. *The Safety and Soundness Act, which governs the Enterprises' base capital framework, is an appropriate starting point for development of a leverage ratio.*

The Proposal would apply the same ratio against both held and transferred assets. Without a distinction between the two, it is difficult in our view to calibrate a suitable backstop that is not binding, because of the differences in risks between the transferred, yet guaranteed, trust assets and those held on-balance sheet. A backstop generally would need to be materially *lower* than that proposed by FHFA because of the risk differential between the Enterprises and the banks, but it also would need to be *different* in order to backstop separately the different risks between on-balance-sheet assets and the guaranteed trust assets. Use of ATA, as compared to the Safety and Soundness Act's bifurcated approach, distorts the analysis because such a large portion of our ATA consists of the assets that we have transferred, but for which we have received matched funding and for which we estimate smaller, contingent risks than those that we hold on-balance sheet. These proposed modifications address the drawbacks of the leverage ratio in the Proposal, which is too high and too binding across multiple historical and future scenarios.

The Safety and Soundness Act provides a framework that is tailored to the Enterprises' business model. The statute recognizes the different risks between held and transferred assets. The Safety and Soundness Act was intended to "strike a balance in terms of the amount of capital required,"[108] and to make a distinction between "held assets" and "passed-through assets."[109] This distinction implies that Congress believed that residential mortgages guaranteed by the Enterprises (in contrast to those held for investment) are lower-risk—a distinction that Congress maintained in subsequent legislation modifying the regulatory treatment of the Enterprises.[110] Also, Treasury specifically proposed the bifurcation that was eventually enacted and explained their proposal as "separate percentages for on- and

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107 Proposal at 39,277.

108 137 Cong. Rec. at H6834 (daily ed. Sept. 25, 1991) (statement of Rep. Bruce Vento).

109 Rep. Leach Statement.

110 *See* HERA.

off-balance sheet assets."[111] Additional statements by a senior Treasury official confirmed their proposed distinction between "total on-balance sheet assets" and "total face value of outstanding [MBS]."[112] Treasury and the Department of Housing and Urban Development noted the different risks posed by assets in either category as a factor in favor of drawing this distinction.[113] Former Federal Reserve Chairman Paul Volcker also corroborated the bifurcated application of a leverage ratio to the Enterprises, in contrast to a bank model.[114] The Congressional Budget Office has similarly noted that the passed-through capital charge generally applies to assets that present minimal risk to the Enterprises.[115] That consensus reinforces Congressional intent to establish leverage capital requirements that account for the risk of assets held in contrast to assets securitized by the Enterprises. In addition, the Safety and Soundness Act clearly delineates the principles upon which a capital framework should be based. Those principles of bifurcated treatment of the risks of held assets and transferred assets are reflective of the business activities and the business model of the Enterprises, rather than of any accounting standard.

Accounting standards are also relevant to our point that the bank leverage capital framework is not suitable for the Enterprises. Leverage ratios in the international bank capital framework were designed to ignore accounting differences among different jurisdictions by incorporating both on- and off-balance-sheet items regardless of where the line is drawn under a jurisdiction's accounting principles.[116] Therefore, the concept of the ATA may be appropriate

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111 *Legislative Proposals to Ensure the Safety and Soundness of Government-Sponsored Enterprises Before the S. Comm. on Banking, Hous., and Urban Affairs*, 102nd Cong. 119 (1991) ("Senate Hearing Report") (responses to written questions of Sen. Sasser from Robert R. Reischauer, Director, Cong. Budget Office).

112 *Id.* at 135 (responses to written questions of Sen. Sasser from Robert R. Glauber, Under Sec'y for Finance, Treasury).

113 *See id.* at 24 (responses to oral questions of Sen. D'Amato from Under Sec'y Glauber) ("Clearly, they would have to treat on balance sheet and off balance sheet items differently, as I think is clear. These kinds of tasks are performed in the private markets all the time. Private markets deal with the debt issued by institutions, firms that are at least as complex as Fannie Mae and Freddie Mac, and the markets are able to make judgments about relative risk. It can be done with these institutions as well, but I do agree . . . that you have to have flexibility in the standards."); *Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991 Before the Subcomm. on Hous. and Cmty. Dev. of the H. Comm. on Banking, Finance, and Urban Affairs*, 102nd Cong. 9 (1991) (statement of John C. Weicher, Assistant Sec'y for Policy Dev. and Research, U.S. Dep't of Hous. and Urban Dev.) (noting that capital requirements would be "calculated by ratios based on the levels of portfolio assets and mortgage-backed securities outstanding, reflecting the differences in risks in these two kinds of businesses. . . . Mortgages held in portfolio are much riskier than mortgage-backed securities; they are subject to interest-rate risk as well as credit risk.").

114 *See* Second Roundtable Hearing on the Safety and Soundness of Fannie Mae and Freddie Mac Before the Subcomm. on Hous. and Urban Affairs of the S. Comm. on Banking, Hous. and Urban Affairs, 101st Cong. 142 (1990) (Letter from Paul A. Volcker, James D. Wolfensohn Incorporated, to David O. Maxwell, Chairman of the Board and CEO, Fannie Mae).

115 *See* Congressional Budget Office, *Measuring the Capital Positions of Fannie Mae and Freddie Mac* (June 2006), at 4 n.7 ("Even though the volume of outstanding guarantee commitments does not directly affect the [Enterprises'] reported liabilities and capital, the minimum capital regulations require Fannie Mae and Freddie Mac to hold 45 cents of additional capital for each $100 of outstanding guarantee commitments.").

116 *See* Basel Committee, *Basel III leverage ratio framework - Executive summary* (Oct. 25, 2017) (the leverage ratio framework "also aims to make use of accounting measures to the greatest extent possible, while at the same time addressing concerns that (i) different accounting frameworks across jurisdictions raise level playing field

when developing a uniform standard across hundreds of international banks, based and operating in many different countries, so that regulators may use the standard as a common benchmark. There are, however, only two Enterprises, operating solely in the United States under an existing statute that recognizes our unique business models. FHFA has an opportunity to tailor a leverage ratio[117] to be consistent with the statutory leverage ratio and with the business and risk profile of the Enterprises.

Even well after the enactment of the Safety and Soundness Act, FHFA has continued to recognize the distinction in risks between held and transferred assets, and the agency has supported the policy of differentiation of the two types of assets. FHFA has cited the difference in funding models between the "non-trust assets" funded by an Enterprise's own debt, equity and derivatives, and MBS or PC debt trust assets funded by third parties.[118] The former are more likely to be subject to deleveraging pressure if the Enterprise requires funds; the latter would not be subject to such pressure as the underlying assets are funded with long-term pass-through securities.

D. *The Enterprises are different from banks in many ways, and consideration of the different business models and risk profiles is necessary to inform the entire Enterprise capital framework, and particularly the leverage capital requirements.*

As we have indicated throughout these comments, the bank capital framework may be informative in certain respects, but FHFA should tailor the framework to the business and risk profiles of the Enterprises. An insufficiently tailored leverage ratio can result in the unintended consequences that we discuss throughout these comments, *i.e.*, inefficient economic decisions, disincentives to engage in CRT, disproportionate impact on lower-risk segments of our portfolio, negative effects on the Enterprises' market competitiveness, etc.[119]

To avoid such unintended consequences, the leverage capital requirements should be tailored to the lower risk profiles of the Enterprises relative to banks.[120] In explaining the

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issues and (ii) a framework based exclusively on accounting measures may not capture all risks."). *See also* Ernst & Young, *Basel Committee tightens leverage ratio requirements* (July 2013) ("The overall goal of the BCBS clarifications is to promote greater consistency across banks subject to different accounting regimes.").

117 Statutory capital requirements "adapt the rules of banks and thrift regulators in a way that takes advantage of the narrower scope and much smaller number of institutions to be regulated and supervised by" FHFA. S. Rep. No. 102-282, at 19 (1992).

118 2018 Proposal at 33,384.

119 *See* Sections I.E and III.A. FHFA acknowledged that the lower requirement for guaranteed trust assets was also meant to "avoid incentives that could reduce the amount of CRT transactions conducted by the Enterprises and other distortions in the Enterprises' marginal economic decision-making." 2018 Proposal at 33,383. Specifically, to encourage CRT, the leverage ratio calibration must not be binding on a post-CRT basis. *Id.* at 33,386-7 ("A binding minimum leverage ratio could also have an impact on the Enterprises' incentives to conduct [CRT] transactions. . . . [A leverage ratio set too high] would likely result in an Enterprise declining to conduct these CRT transactions . . . If capital requirements caused the Enterprises to reduce the amount of CRT transactions they conducted, this could result in a greater concentration of credit risk with the Enterprises and could be counter to FHFA's overall objective of reducing credit risk to the Enterprises and taxpayers.").

120 Establishing a leverage ratio should also take into account the significantly less risky portfolio and acquisition standards of the Enterprises since conservatorship. A newly imposed leverage capital requirement

calibration of the leverage requirements in the Proposal, FHFA relied specifically on a comparison of the proposed leverage requirements to similar requirements for the U.S. G-SIBs.[121] The Proposal's comparisons, however, do not adequately reflect the different business models and risk profiles of the Enterprises in contrast to the U.S. G-SIBs.

The differences in business models between the Enterprises and the U.S. G-SIBs result in comparatively and materially lower risk retention, and thus, risk profiles for the Enterprises. An entity with a business model that results in a lower risk profile should have a lower leverage ratio requirement in order to avoid the requirement becoming binding more frequently and/or in inappropriate contexts as against the risk-based requirements. However, as shown in Appendix F.3, U.S. commercial bank G-SIBs' and selected regional banks' risk-based capital requirements generally exceed their leverage ratio requirements (both with and without the eSLR buffer).[122] The opposite occurs for Freddie Mac, as the proposed leverage ratio requirements exceed the proposed risk-based capital requirements over historical and forward-looking scenarios. As shown in Appendix F.4, the bank capital framework's SLR has not been a materially binding constraint for the U.S. commercial bank G-SIBs between 2014 and 2019, even taking into account the 2% eSLR buffer. The leverage requirement also has not been the binding constraint for U.S. regional banks between 2014 and 2019.[123] Yet, as shown in Appendix F.1, the proposed leverage ratio would be binding for Freddie Mac across most of

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should be based on the business we are in and on the business we are permitted to undertake. Sections II.2 and III.A above discuss our improvements in portfolio mix, enhancements to underwriting standards, increase in CRT, reduction in legacy and PLS portfolios, adoption of improved accounting standards (CECL), and overall increase in rigor of supervisory standards.

[121] Proposal at 39,294 ("[T]he proposed leverage ratio requirements are generally aligned with the analogous leverage ratio requirements of U.S. banking organizations . . . ."); *id.* at 39,301 ("FHFA also looked to the sizing of similar leverage buffer requirements under the U.S. banking framework [to size the PLBA].").

[122] We note that banking regulators have been concerned about the potential binding nature of the leverage ratio in the banking capital framework and have moved to avoid that occurring. *See, e.g.*, Basel Committee, *Basel III: Finalising Post-Crisis Reforms* (Dec. 2017), https://www.bis.org/bcbs/publ/d424.pdf; Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions, Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies, 83 Fed. Reg. 17,317, 17,319-20 (Apr. 19, 2018) ("Over the past few years, banking organizations have raised concerns that in certain cases, the standards in the eSLR rule have generally become a binding constraint rather than a backstop to the risk-based standards. . . . Accordingly, in light of the experience gained since the initial adoption of the eSLR standards, and to avoid potential negative outcomes, the Board and the OCC are proposing to recalibrate the standards in the eSLR rule."); Federal Reserve Stress Capital Buffer Rule at 15,582 (stating that "not imposing a stress leverage buffer requirement increases the likelihood that risk-based requirements will be the binding requirement for firms"); Randal K. Quarles, Vice Chair for Supervision, Federal Reserve, *Statement by Vice Chair for Supervision Quarles* (Mar. 4, 2020), https://www.federalreserve.gov/newsevents/pressreleases/quarles-statement-20200304a.htm; Economic Growth, Regulatory Relief, and Consumer Protection Act, Public L. No. 115-174, § 402, 132 Stat. 1296, 1359 (2018); Regulatory Capital Rule: Revisions to the Supplementary Leverage Ratio to Exclude Certain Central Bank Deposits of Banking Organizations Predominantly Engaged in Custody, Safekeeping, and Asset Servicing Activities, 85 Fed. Reg. 4,569 (Jan. 27, 2020).

[123] These results hold even for the third quarter of 2019, which was specifically highlighted by FHFA in the Proposal.

the last 18 years and across severely adverse forward-looking scenarios, thus indicating inappropriate calibration for the overall risk profile and business model of Freddie Mac.

We also conducted comparisons of the risk profiles of Freddie Mac against several banks that hold large portfolios of mortgages, including U.S. commercial bank G-SIBs. To conduct these comparisons, we used RWA density analyses as a proxy for risk. However, consistent with our recommendation on the leverage ratio requirements, the RWA analyses are based on credit risk measures and do not account for the lower-risk business model and the more stable liability structure of the Enterprises. Nevertheless, the comparisons are informative.

As shown in Appendix F.5, calculating RWAs under the Proposal without consideration of our other recommendations reflected in these comments, Freddie Mac has lower RWA density than that of the U.S. commercial bank G-SIBs, including those with large mortgage portfolios, as well as lower RWA density than that of selected regional banks that engage in significant retail and mortgage lending. This lower RWA density means that Freddie Mac has a lower overall risk profile than the U.S. commercial bank G-SIBs and the selected regional banks under the risk-based capital analyses. While Appendix F.5 indicates that Freddie Mac's overall aggregate RWA density over the 2014-2019 period is consistently and significantly lower by 40% or more, Freddie Mac also performed an RWA density comparison across three different calculation approaches.[124] Over those three approaches, Freddie Mac's RWA density is also consistently and significantly below that of the U.S. commercial bank G-SIBs and the large regional banks included in the comparison. Freddie Mac has RWA densities within a range of 27-32% across the three calculation approaches, while U.S. commercial bank G-SIBs' and selected regional banks' aggregate RWA density yields measurements in the range of 50-54%. The fact that the relative RWA density is similar across several analyses validates the relative risk conclusion that we posit in these comments and supports our recommendation that the leverage capital requirements be tailored more closely to the risks and business model of the Enterprises.[125]

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[124] Freddie Mac would have RWA density within a range of 27–32% over three scenarios, and U.S. commercial bank GSIBs and selected regional banks would have RWA density within a range of 50-54% over the same approaches:

Aggregate RWA density across the total balance sheet, at September 30, 2019: Freddie Mac RWA density of 27% versus the selected bank RWA density of 50% indicates Freddie Mac at 53% relative to the risk of the selected banks.

Advanced approaches RWA density for mortgages only, over the period 2014-2019: Freddie Mac mortgage RWA density of 32% vs. the selected bank mortgage RWA density of 54% indicates Freddie Mac at 60% relative to the risk of the selected banks.

Basel IV standardized mortgage risk weights, at September 30, 2019: Freddie Mac Basel IV mortgage RWA density of 31% vs. the selected bank Basel IV mortgage RWA density of 50% indicates Freddie Mac at 62% relative to the risk of the selected banks.

[125] We would expect that Freddie Mac's RWA density over many types of analyses would be lower historically and indefinitely into the future than the G-SIBs, given that Freddie Mac is restricted to mortgage activities, while the G-SIBs engage in a broad range of complex activities, including leveraged lending, prime brokerage, derivatives and securities dealing and clearing and securities underwriting.

There are several reasons why the Enterprises exhibit lower risk than banks, and the analyses above quantitatively prove that risk differential. The Enterprises' business models are largely based on passing liquidity, credit, interest rate and prepayment risks to private investors. With the development of pass-through MBS more than 40 years ago, Freddie Mac transfers interest rate and liquidity risk on an overwhelming majority of our exposures. Investors who buy Enterprise MBS know that they are assuming interest rate risk, have no expectation they will be insulated from it and have no ability to put the MBS back to the Enterprise. This matched funding does not carry maturity transformation or maturity mismatch risk that is the hallmark of the bank asset-liability model. Freddie Mac also uses CRT to mitigate (in increasing amounts and effectiveness since 2013) our guarantee business-related credit risk. Banks, in contrast, tend to take full intermediation risk as principal for credit and interest rate risks in their retained portfolios.[126]

The Enterprises are also monoline businesses focused on a traditional, well understood and secured asset class. We focus solely on mortgage assets, while banks have more diversified sources of income and assets. Unlike banks, the Enterprises also do not engage in businesses that regulators deem "complex" or riskier, such as leveraged lending or securities dealing. Banks often maintain material amounts of assets that are less liquid and less easily securitized than the mostly match-funded balance sheets of the Enterprises. Nevertheless, FHFA noted that the Enterprises' monoline nature "suggests that the concentration risk of an Enterprise might be greater than that of a diversified banking organization with a similar amount of credit risk," indicating that the leverage enhancements in the Proposal are necessary for this reason.[127] However, even when comparing risk specifically associated with mortgage lending, the Enterprises hold less risk compared to the mortgage investments of banks.[128]

Additionally, the Enterprises, unlike banks, are largely shielded from liquidity risk through the sale of long-term PC debt. The Enterprises are not subject to the equivalent of a run on deposits or drying up of short-term wholesale funding, which can affect banks in a stress environment. Long-term PC debt is fully paid for, and investors cannot put debt back to the trust or to the Enterprise. This structure significantly mitigates, or even eliminates, run risk. Therefore, even in a downturn the assets stay funded, unless they are removed to the Enterprise's balance sheet, in which case they will be subject to a higher capital charge. There is no need to roll over funding or to seek additional funding to replace retired liabilities in connection with PC debt. The Enterprises are therefore able to act differently and more deliberately in a downturn to address risks in the guaranteed pools, unlike banks which generally must address short-term

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[126] FHFA has indicated that banks hold a greater degree of risk for the whole residential mortgage loans on their balance sheets compared to Enterprise mortgage assets held in trusts because (i) whole loans held on-balance sheet do not benefit from the match-funding securitization which transfers interest rate and market risk to investors and (ii) banks do not have comparable CRT programs. 2018 Proposal at 33,385.

[127] Proposal at 39,289. We note that this statement on concentration risk appears to be at odds with the Proposal's treatment of CRT. In our view, the Proposal would disincentivize use of CRT, even though CRT broadly disperses credit risk into the market and alleviates the concentration of credit risk in the Enterprises. *See* Section III above.

[128] In footnote 124, we show that under an advanced approaches model for mortgages and under the Basel IV standardized model for mortgages, the risk of Freddie Mac's mortgage exposures is around 60% of the risk of mortgage exposures maintained by selected banks.

demand liability runs and their long-term asset mix through sales (sometimes "fire sales") of assets. This exposes banks to a greater degree of funding risk during times of market and economic stress, and they can fail quickly. Therefore, even for the same asset risk, FHFA should be comfortable with a lower leverage requirement.

FHFA detailed at length this difference in risks in the 2018 Proposal. The explanations offered by FHFA should be no different under the Enterprises' 2020 business model. FHFA explained the differences between the Enterprises and banks, as well as the risk differences between held assets and transferred assets, as follows: the Enterprises purchase single-family and multifamily mortgages that they package into MBS and PC debt and sell to investors, reducing the funding risk of carrying these mortgage assets on-balance sheet.[129] The Enterprises transfer funding, interest rate, market and credit risks to investors, meaning that the risks the Enterprises manage for mortgage assets held in the trusts differ from the risks faced by the Enterprises and banks from the assets they hold in retained portfolios.[130] The securitization process provides the Enterprises with a more stable funding source that is match-funded with the mortgage assets we purchase. Investments in MBS cannot be withdrawn from the Enterprises or our trusts during times of market stress. This contrasts with banking deposits and short-term debt relied on by banks, which can leave banks in need of new funding at times when debt funding becomes harder and more expensive to obtain.[131]

V. The PCCBA

The PCCBA components should be made more risk-sensitive and dynamic. This approach would have the benefit of encouraging risk reduction and incentivizing prudent risk management based on stress testing results and would result in a more integrated capital framework across the risk-based capital requirements, stress testing requirements and buffers.

A. *The stress capital buffer component should be made more dynamic and risk-based by replacing the static 0.75% of ATA buffer with a measure based on stress testing performance.*

The stress capital buffer should be risk-sensitive and vary based on market conditions and the Enterprises' balance sheets through the credit cycle. Our proposed approach would more closely resemble the effective elements of the bank capital framework on which much of the Proposal is based, resulting in a more efficient framework that integrates stress testing and capital requirements. Under that framework, each participating bank's stress capital buffer is determined in substantial degree based on the maximum projected decline in its common equity tier 1 ("CET1") capital ratio under a severely adverse stress testing scenario, expressed as a percentage of RWA.[132] Based on recently announced 2020 results, the six non-custody G-SIBs' stress capital buffers (including four quarters of expected dividends) would

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129 *Id.*

130 *Id.* at 33,385.

131 *Id.*

132 Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules, 85 Fed. Reg. 15,576, 15,578 (Mar. 18, 2020) (the "Federal Reserve Stress Capital Buffer Rule").

range from 2.5% (due to the floor, or 1.9% without the floor) to 6.7%.[133] That range demonstrates the dynamic and risk-sensitive nature of the Federal Reserve's method, which we believe would deliver substantial safety and soundness benefits if applied to the Enterprises.

In the Proposal, FHFA suggested an alternative to the flat 0.75% stress capital buffer that would "periodically re-size the stress capital buffer" based on Enterprises' stress tests.[134] We recommend that FHFA adopt a variant of this alternative and implement an approach similar to the Federal Reserve's stress capital buffer. Our recommendation would retain the Proposal's use of ATA as the anchor for the stress capital buffer, while providing for yearly recalibration based on DFAST performance.

We believe our recommendation is appropriate for several reasons. First, mirroring bank stress capital requirements should result in consistency with bank competitors (and counterparties) that are also subject to a similar stress capital buffer framework.[135] Second, our recommendation replaces the static measure with a dynamic one that is expected to utilize scenarios similar to the ones developed by the Federal Reserve and FHFA in relation to DFAST that are inherently countercyclical. Third, incorporating stress testing into capital planning would continue to build on Freddie Mac's established practice of integrating stress testing into everyday risk management.[136] It also would ensure that stress testing becomes an ongoing element of FHFA's capital supervision of the Enterprises. Because poor stress testing performance would result in an effective increase in capital requirements (and a corresponding reduction in return on equity), management would continue to be incentivized to conduct the Enterprises' businesses with sensitivity to performance in adverse economic conditions, at all times. A static buffer of 0.75% by contrast provides no incentive to work on stress-scenario risk management and forecasting. In other words, a "stress" buffer should be linked to performance in stress scenarios and not simply be static. Fourth, a static buffer based on ATA duplicates a leverage ratio requirement, which is separately part of the Proposal. We have separately commented in Section IV about the proposed leverage ratio and PLBA requirements.

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133 *See* Press Release, Federal Reserve, Federal Reserve Board Announces Individual Large Bank Capital Requirements, Which Will Be Effective on October 1 (Aug. 10, 2020) (announcing stress capital buffers of Bank of America (2.5%), Citigroup (2.5%), Goldman Sachs (6.7%), JP Morgan (3.3%), Morgan Stanley (5.9%) and Wells Fargo (2.5%)).

134 Proposal at 39,297.

135 We respectfully disagree with FHFA's statement that the requirement for an Enterprise stress capital buffer "should not be construed to imply or otherwise suggest that a similar buffer would necessarily be appropriate for other market participants in the housing finance system." *Id.* As the 2007-2009 financial crisis evidenced, other participants in this market, including those that provide credit support but that do not originate, buy or sell mortgage loans, are susceptible to stress and should be prepared for a downturn in the economy and in the real estate market specifically. Freddie Mac desires to face strong counterparties that can provide risk mitigation and related services. Differentials in capital, risk management and ultimately costs created by regulatory requirements may distort the market and provide incentives for arbitrage among market participants, including the potential for concentration of risks in certain participants. Stress testing and capital to ensure viability through the cycle should be part of robust risk management practices on the part of all housing finance market participants.

136 *See also* Federal Reserve Stress Capital Buffer Rule (goal of integrating stress testing with everyday compliance with capital requirements).

Overall, dynamic calibration of the buffer would provide an additional supervisory tool to FHFA and ensure a diversity of approaches to setting capital that would address any unintended consequences of overreliance on one metric through the variability of the credit cycle. We propose the following alternative approach:

- Apply the DFAST severely adverse scenario;
- Over the nine-quarter stress horizon, observe the quarter with the largest cumulative losses;
- Add to those losses an allowance for projected four quarters of dividends (assumed to be 50% of eligible retained income);
- Express that total as a percentage of ATA; and
- As a dynamic measure, reset this stress capital component of the PCCBA each year based on this calculation.

In a severely adverse scenario, our stress capital buffer under the calculation methodology above would be 0.52% of ATA (or 2.0% of RWA), including four quarters of dividends assumed to be 50% of eligible retained income.[137] The announced stress capital buffers for 2020 for the six non-custody G-SIBs range from 1.9% to 6.7% (with four quarters of expected dividends, but setting aside the banking framework floor). The potential sizing of our buffer at approximately 2.0% of RWA would therefore not be an outlier and would account for the lower risk in Freddie Mac's portfolio, through a stress-scenario cycle, relative to the G-SIB balance sheets.

The stress capital buffer floor for U.S. banking organizations is calibrated at 2.5% of RWA. A floor is not necessary for the Enterprises. The U.S regulator's floor is set at the capital conservation buffer ("CCB") that is applicable to all banks. This is not a tailored calibration, but one chosen to apply across the thousands of banks in the United States. The U.S. banking agencies need to take into account considerations different from those that apply to FHFA in its capacity as regulator of two unique Enterprises. Namely, those agencies must consider that the CCAR bank stress capital buffer, as a replacement for the CCB, should not go below the CCB mandated for all banks. In addition, the Basel Committee has set the international CCB at 2.5%. The Basel Committee frameworks apply to banks and not to analogs of the Enterprises. Therefore, there are also international reasons to keep the U.S. CCAR banks at a buffer level not below thousands of other banks outside the United States. FHFA is not subject to such constraints with regard to the unique, domestically-focused Enterprises. Furthermore, the overall leverage capital requirements would remain as a backstop to any measurement or stress-scenario model projection risk,[138] and an additional non-risk-based floor

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[137] While the quarter with the largest cumulative losses yields a buffer of 0.52% of ATA, Freddie Mac's cumulative losses over the full nine-quarter stress horizon under a severely adverse scenario (including adjustments for model risk) were 36 bps.

[138] We are not aware that the Federal Reserve has seen any model risk distortions in its DFAST and CCAR stress tests.

at the buffer level would only serve to reduce risk sensitivity, layer redundant static capital requirements and undermine the purpose of using a stress-test-based buffer.

Moreover, the overall concept of a dynamic and potentially fluctuating stress capital buffer without a floor is appropriately tailored for the Enterprises. Our analysis of recent DFAST results for banks demonstrates that their risk profiles have varied significantly over time and from bank to bank, even for those with similar geographic footprints and business models. However, Freddie Mac's pre-tax losses under a severely adverse scenario as a percentage of total assets have consistently declined between 2016-2019 (and are expected to decline again under the 2020 severely adverse scenario). In comparison, the banks' losses have significantly fluctuated over that period. See Appendix G.1. This analysis demonstrates that the dynamic alternative to sizing the stress capital buffer that we propose would suitably recognize the stability of (and recent improvements in) our business model, risk management and overall performance. In light of that stability and the clear positive trends, switching to a more risk-sensitive measure would still permit FHFA to realize the benefits that it believes would accompany a proposed stress capital component, while providing for additional calibration, countercyclicality (through the scenarios of the stress tests) and appropriate tailoring.

B. *The stability capital buffer component should be replaced with FHFA's alternative proposal to adopt the G-SIB systemic risk buffer.*

The Proposal would size the stability capital buffer component of the PCCBA by reference to each Enterprise's share of total residential mortgage debt outstanding.[139] This methodology for determining a stability buffer is primarily a proxy for size. This approach represents a stark contrast to the U.S. bank capital framework and the Basel framework that use several risk-based indicators to arrive at a buffer that reflects the risks posed by a mix of overall size and activities. Consistent with the general principle that the Enterprises' capital framework should be mortgage-risk-sensitive (and not just size-sensitive), we believe that the stability capital buffer should focus on the Enterprises' systemic activities, should more closely resemble the approach for banks and should align with internationally agreed principles.[140] Size alone is not a suitable metric, particularly in relation to the Enterprises, which distribute a significant portion of our credit, liquidity and interest rate risks in a broadly diversified manner. The disconnect between the size of the Enterprises and the riskiness of our asset and liability mix, in turn, suggests that a buffer intended to address systemic risk concerns with the failure of an Enterprise should be appropriately calibrated to account for this feature of our business.[141]

FHFA proposed an alternative approach for the stability capital buffer component based on G-SIB systemic risk scoring.[142] In suggesting this methodology, FHFA requested

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139 Proposal at 39,298. The buffer would be expressed as a percentage of ATA and would increase by 5 bps for each percentage point of market share exceeding 5%.

140 Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 Fed. Reg. 49,082 (Aug. 14, 2015) (the "G-SIB Surcharge Rule"); Basel Committee, *The G-SIB assessment methodology – score calculation* (Nov. 2014).

141 *See, e.g.*, Appendix F.5 (indicating that Freddie Mac's RWA density (*i.e.*, risk relative to size) is only slightly more than half of that determined for most comparable G-SIBs).

142 Proposal at 39,300-01.

comment on how the systemic risk scoring should be applied to the Enterprises.[143] We agree with the alternative and recommend that FHFA replace the market share approach with a modified version of the U.S. bank capital framework's consideration of risk-based indicators to determine a G-SIB's systemic risk score and capital surcharge. In keeping with the risk-sensitivity goal of FHFA, this approach would help ensure the Enterprises' resiliency and result in a more risk-sensitive and better-tailored buffer.

Based on our internal projections, and incorporating the calculation methodologies described below in this Subsection V.B, this alternative approach would result in a stability capital buffer of 1.0% of RWA (based on Freddie Mac landing in the 1.0% band under the G-SIB systemic risk scoring) or 28 bps of ATA.[144] Based on internationally-agreed measures for relative risk among large financial institutions, Freddie Mac poses less risk to the financial system than many of the U.S. and international G-SIBs that are in higher bands using the same G-SIB systemic risk scoring methodology. Our stability capital buffer should therefore be set dynamically, so as to internalize our systemic risk, but at an amount lower than systemically important institutions with higher-risk profiles.

1. The stability capital buffer for the Enterprises should use all five of the indicators in Method 1 of the bank capital framework.

The stability capital buffer should use a score based on Method 1 of the G-SIB systemic risk framework.[145] Method 1 is the approach employed in both the U.S. and the international systemic risk measurement framework[146] and should form the basis of the buffer calculations in the Enterprises' capital framework. The Federal Reserve's modifications in "Method 2"[147] of the systemic risk scoring are not aimed at institutions such as the Enterprises and are not employed in the international systemic risk framework. Method 2 is designed to address the idiosyncrasies of institutions that have "reliance on short-term wholesale funding [of less than one year that] can leave firms vulnerable to runs that undermine financial stability,"[148] including through short-term repurchase transactions[149] and brokered deposits.[150] That is not the case with the Enterprises, which generally use match funding for our mortgage exposures with maturities much greater than a year and which are not dependent upon repurchase agreements

143 *See* Proposal at 39,301.

144 Under our calculations, our G-SIB systemic risk score would be 152.

145 *See* 12 C.F.R. § 217.404.

146 *See* Basel Committee, *Global systemically important banks: revised assessment methodology and the higher loss absorbency requirement* (July 2018).

147 12 C.F.R. § 217.405.

148 G-SIB Surcharge Rule at 49,088.

149 Market commentators have generally perceived a focus of the Method 2 score on broker-dealer operations with short-term repurchase operations. *See, e.g.*, Victoria McGrane and Ryan Tracy, *Fed to Hit Biggest U.S. Banks with Tougher Capital Charge*, Wall St. J. (Sept. 9, 2014).

150 *See* G-SIB Surcharge Rule at 49,100 ("The final rule treats brokered deposits as short-term wholesale funding because they are generally considered less stable than standard retail deposits.").

and short-term "runnable" deposits. Any issues related to funding of the Enterprises can also be addressed in liquidity guidelines for the Enterprises.

The Method 1 approach should apply all five risk-based indicators to the Enterprises.[151] This approach would provide appropriate credit for the Enterprises' lower cross-jurisdictional activities and lower complexity than U.S. G-SIBs. These indicators, as with the other three, are important contributors to the systemic impact caused by the potential failure of a financial firm. A large global presence may make an institution "more difficult and costly to resolve than purely domestic institutions," while organizational complexity may similarly increase the "expense and time necessary to resolve" the institution.[152] To the extent a U.S. G-SIB faces a higher surcharge due to elevated levels of these risk-based indicators, so too, would a U.S. G-SIB face a lower surcharge due to effective management of these risk-based indicators.[153] The same approach—applying both the benefits and burdens for each of the inputs to Method 1—should apply to the Enterprises because the surcharge has been carefully designed and calibrated to holistically price the negative externalities of a financial institution's systemic riskiness. For example, although several U.S. G-SIBs report null values for inputs in multiple Method 1 indicators, those line items are still incorporated into their overall systemic risk score.[154] In the same manner, if the Enterprises' limited international footprint and monoline business model reduce our risk to the financial system, then those core elements of our business models should be reflected in those elements of our regulatory capital framework that are designed to account for financial stability concerns.

Excluding certain risk-based indicators would distort the methodology and treat the Enterprises as if we were significantly systemic with regard to complexity and cross-jurisdictional activity. Because the systemic risk scoring methodology is relative to other financial institutions in the market, exclusion of these two factors does not discount their importance, but conversely treats each of these factors as equally important as the other three factors for the Enterprises. When two factors are excluded, the other three factors contribute a greater percentage of the total risk score. But because the scores are based on the factors totaling to 100%, the excluded scores are treated as if they were equivalent to the weighted average of the other three. In other words, the deficit between the three indicators and 100% is made up by expanding the positive amounts of the three considered indicators to make up the total to 100%. This is the opposite of what should be intended and what we think FHFA meant when it indicated that perhaps cross-jurisdictional activity and complexity were not as relevant for the

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151 Proposal at 39,301.

152 G-SIB Surcharge Rule at 49,096-97.

153 For example, certain G-SIBs may have much lower substitutability scores than the more narrowly focused custody banks. Indeed, it may be that one or more of the G-SIBs have little involvement in the broader international custody and trust market. However, the substitutability score, which affects the custody banks to a significantly greater degree (and, for that reason, is even capped for them), is not eliminated for other banks that are not significantly systemic in that score.

154 *See* FFIEC, *FR Y-15 Snapshots Reports as of December 31, 2018* (Nov. 2019), https://www.ffiec.gov/npw/StaticData/Y15SnapShot/20181231_20190723_FRY15%20Snapshot%20PDF.pdf. (reporting zero level 3 assets for one U.S. G-SIB in the complexity indicator and zero underwriting assets in the substitutability indicator for another U.S. G-SIB).

Enterprises. We agree these factors are not as relevant, but that is precisely the reason to apply all five factors in the analysis.[155]

2. The interconnectedness indicator should be modified to exclude PC debt.

PC debt is not issued directly by the Enterprises, but by various over-collateralized trusts backed by the assets and payments on underlying mortgages sold by an Enterprise to the trusts. PC debt is reported as on-balance sheet only due to accounting standards issued after the financial crisis relating to consolidation of variable interest entities and standards for "derecognizing" transfers of financial assets.[156]

In addition, PC debt exemplifies the disconnect between the size of the Enterprises and our riskiness. PC debt may, as an accounting matter, increase the "size" of the Enterprises, but the underlying risks of the loans and the guarantee are mitigated in many ways through pass-through of risks and CRT transactions. PC debt would be a large component of the size indicator under the systemic risk scoring, and including it in the interconnectedness indicator would be double-counting a size element rather than an interconnectedness risk element. Accordingly, the final rule should exclude PC debt from the interconnectedness indicator.

3. The denominator of the scoring methodology should include both Enterprises' total reported activity across the indicators.

The G-SIB systemic risk scoring under Method 1 is performed on a relative basis against other financial institutions in the market.[157] Each systemic risk indicator is derived from a weighted ratio of the institution's score and the "aggregate global indicator" amount (the sum of the systemic indicator scores of the 75 largest U.S. and foreign banking organizations as measured by the Basel Committee) published by the Federal Reserve each year.[158] In order to suitably calculate the systemic risk score of each of the Enterprises, the G-SIB systemic risk denominator should include both Enterprises' systemic indicator scores in addition to the financial institutions' aggregate global indicator scores. The Basel Committee and the Federal

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155 We note that the preamble to the Proposal discusses potential elimination of the cross-jurisdictional activity and complexity indicators (*see* Proposal at 39,301, and particularly Question 20 on that page), but the rule text proposed for the alternative appears to eliminate the substitutability indicator rather than the complexity indicator (*see* Proposal at 39,406, proposed alternative § 1240.400(b)(1)). We assume that the preamble describes the intended alternative.

156 Financial Accounting Standards Board ("FASB"), *Financial Accounting Statement No. 166, Accounting for Transfers of Financial Assets* (June 12, 2009); FASB, *Financial Accounting Statement No. 167, Amendments to FASB Interpretation No. 46(R)* (June 12, 2009).

157 *See* Basel Committee, *Global systemically important banks: revised assessment methodology and the higher loss absorbency requirement* (July 2018), at ¶¶ 17 and 26; G-SIB Surcharge Rule at 49,085-86.

158 *See, e.g.*, Regulation Q; Regulatory Capital Rules: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 84 Fed. Reg. 69,744 (Dec. 19, 2019).

Reserve add to the aggregate global indicator any institution that is systemic, and we agree that the Enterprises should be added when calculating our scores.

C. *The countercyclical capital buffer component should not be adopted.*

We appreciate that FHFA has sought to improve upon the 2018 Proposal by incorporating countercyclical adjustments, and we believe that those revisions have generally addressed concerns that the 2018 Proposal was procyclical. For example, the standardized approach to credit risk would provide for a countercyclical adjustment to a single-family mortgage exposure's MTMLTV, which is expressly designed to be responsive to macro-economic drivers of potential stress for the Enterprises.[159] Indeed, in Subsection II.C.2, we have recommended a countercyclical adjustment to multifamily exposures. To take a more general example, the leverage ratio also serves as a backstop or floor to the risk-based measures in appropriate circumstances in order to, in part, counter potential procyclicality of risk-based measures. Our proposals also recommend better linkage to dynamic stress-test based results, which incorporate (through rigorous stress scenarios) various elements of countercyclicality. Therefore, the countercyclical capital buffer as a "backstop" is not necessary—the proposed framework's approach to credit risk already embeds countercyclical adjustments.

Further, the U.S. banking agencies have not deployed this tool. The preferred approach has instead been to provide targeted relief from rules that may drive procyclical behavior. Statements by Vice Chair Randal Quarles of the Federal Reserve indicate that the strength of the banking agencies' capital requirements and the visibility into sources of systemic risk through supervisory stress tests have potentially obviated the need for a countercyclical capital buffer.[160] Moreover, deploying the countercyclical buffer requires substantial judgment regarding the build-up of vulnerabilities in the financial system against macro-economic risks. The subjective nature of the assessment to effectively raise capital requirements through the countercyclical capital buffer suggests that there will be challenges in effectively administering it. When it is imposed, it would typically not be imposed on a timely basis, as analyses and phase-in periods are required. If imposed, it is unlikely to be removed or reduced during economic downturns, when it theoretically should be removed to provide for greater ability to deploy capital. This subjectivity and potential for the buffer to become integrated with structural capital requirements once deployed could create uncertainty for investors and counterparties.

VI. Advanced Approach for Credit and Market Risk

The Proposal would require the Enterprises to calculate our RWA using both the standardized approach and the models-based advanced approach, with our risk-based capital requirements based on the higher of our RWA calculated under both methodologies. The proposed adoption of the advanced approach is intended to allow the Enterprises to take advantage of the advanced approach's increased risk sensitivity to tailor our risk measurement processes in a manner consistent with our size and complexity. We recommend that FHFA not

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159 Proposal at 39,303.

160 Randal K. Quarles, Vice Chair for Supervision, Federal Reserve, Refining the Stress Capital Buffer (Sept. 5, 2019), https://www.federalreserve.gov/newsevents/speech/quarles20190905a.htm.

adopt the advanced approach for credit risk and market risk. Instead, the Enterprises' existing internal modeling should inform the standardized approach.

A. *The advanced approach for credit risk and market risk should not be adopted. The proposed standardized approach has incorporated significant risk sensitivity, particularly with regard to mortgage exposures that make up most of the Enterprises' assets.*

The standardized approach under the Proposal is significantly more granular and risk-sensitive with respect to mortgage exposures (the Enterprises' primary asset exposure) than the standardized approach applicable to banking organizations. The standardized approach in the Proposal uses a robust framework of look-up grids and risk multipliers, developed with significant input from the Enterprises over several years, and is based generally on existing internal models produced at the Enterprises. Requiring the creation of a different set of models than those already incorporated in the standardized approach would be inefficient and duplicative. The standardized approach also includes MTMLTV measures, which reflect changing risk and are more risk-sensitive than the original LTV measures used under the standardized approach applicable to banking organizations.

With respect to market risk, the standardized approach provides multiple methodologies that are designed to capture the primary drivers of spread risk for different covered positions. Over half of Freddie Mac's market-risk RWA as of 3Q 2019 is already calculated through the Proposal's Internal Models approach, which incorporates suitable risk granularity designed to measure the specific spread risk of the products in Freddie Mac's portfolio with the most complex risk profiles and risk factors. Among the remainder of assets, those using the proposed Spread Duration approach have a reasonable level of risk differentiation because the spread durations are calculated through internal models that also incorporate assumptions around other risk factors, *e.g.*, prepayment risk. Finally, the assets whose market risk is calculated under the proposed Single Point approach (primarily re-performing loans and NPLs for Freddie Mac) have a relatively high amount of credit risk, over a range of credit risk differentiation, and are not as sensitive to other risk factors such as prepayment risk. In addition, even if more risk differentiation in the market risk component of these loans were required, historical data on spreads that would be necessary for a reasonable market risk advanced approach (*e.g.*, value-at-risk or expected shortfall measures) are not generally available.

In Freddie Mac's view, the Proposal did not provide sufficient justification for requiring use of the advanced approach, other than potentially to improve risk management techniques. Risk management can be improved through FHFA's supervisory process and the Enterprises' existing internal modeling. We also note that the Enterprises are separately subject to significant risk discipline. In addition to the more granular standardized approach, the Enterprises are subject to DFAST and are required to use supervised internal models that both inform capital sufficiency and obviate the need for parallel models-based capital analyses for our monoline, non-complex activities.

While we agree with the flexibility that FHFA would incorporate into an advanced approach regime with "significant latitude in the scope and design,"[161] that flexibility can be harnessed as a "Pillar 2" supervisory matter through interactions between FHFA and the Enterprises, rather than a "Pillar 1" capital framework requirement.[162] DFAST and the supervised internal models could be integrated into this dynamic supervisory approach. We also recognize the value of continually improving our internal models so that they may inform the calibration of the standardized approach. If FHFA is concerned that the standardized approach metrics may become stale, Freddie Mac is willing to suggest improvements and revisions to the standardized approach's look-up grids and risk multipliers. To the extent that FHFA has not incorporated into the Proposal a process for the periodic modification of the standardized approach, we would support such an expedited provision in the final rule in order to keep the standardized approach up-to-date and efficient. The use of a separate advanced approach is not needed for these purposes.

Because the Enterprises' risk modeling has already been incorporated into the standardized approach through consultation over the last several years with FHFA, the required development of a *separate, second* set of models different from those currently in use by the Enterprises would entail a significant investment of time and resources that would only serve to delay full compliance with the proposed required capital levels. (For example, it took several years and hundreds of millions of dollars in investment for banks to build Basel II risk models and to obtain approval for their use.)

In particular, any prescriptive approach (whether through Pillar 1 or Pillar 2) that incorporates the banking agencies' Basel II formulae would not be suitably tailored for the significant majority of the risks of the Enterprises and would create ambiguity and opacity.[163]

B. *The U.S. banking agencies and the Basel Committee disfavor the advanced approaches, and the final capital framework should reflect this international consensus.*

U.S. banking agencies and the Basel Committee have increasingly limited their application of the advanced approaches to banking organizations. U.S. banking agencies adopted a final rule in November 2019 that requires application of the advanced approaches only

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161 Proposal at 39,342.

162 *See* Basel Committee, *Overview of Pillar 2 supervisory review practices and approaches* (June 2019) ("The second pillar of the Basel Framework is intended not only to ensure that banks have adequate capital to support all the risks in their business but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. For that reason, Pillar 2 is also described as the supervisory review process.").

163 We also note that the banking agencies' Basel II advanced approaches formulae contain elements of procyclicality, particularly in relation to probability of default metrics, that would be counter to FHFA's goal of reducing procyclical elements of the capital framework. This was demonstrated recently when a number of U.S. G-SIBs became bound by the advanced approaches in the first quarter of 2020 because their advanced approaches RWA exceeded their standardized approach RWA under the Collins Floor for the first time in several years. *See* Louie Woodall, *Credit Models at Odds with the Standardised Approach on COVID Shock*, Risk (May 8, 2020). This increased G-SIBs' capital requirements and reduced credit availability, limiting the G-SIBs' ability to respond to economic challenges caused by the COVID-19 pandemic.

for large, international banks with at least $700 billion in total consolidated assets, up from the original $250 billion threshold.[164] This move limits application of the advanced approaches to the largest banks that are engaged in complex, international activities and halved the number of advanced approaches banks.[165] There are now only nine U.S. banking organizations subject to the advanced approaches and the dual risk-based capital framework. Separately, the Basel Committee, under their Basel IV reforms, removed the requirement for national authorities to implement internal model-based approaches (*i.e.*, advanced approaches); any jurisdiction that implements only the standardized approach will now be compliant with the Basel framework.[166] Further, the U.S. banking agencies are considering elimination of the advanced approaches entirely.[167]

The Enterprises are non-complex entities whose activities are limited in geographic scope compared to the internationally-active banks subject to the advanced approaches. We do not believe it would be efficient, cost-effective or generally effective to require the Enterprises to undertake a significant investment to build duplicative internal modeling systems to support a risk-based capital methodology that is increasingly disfavored.

C. *The use of the Collins Floor is unsuitable for the Enterprises and, therefore, provides further support for simplifying the final capital framework through adoption of the standardized approach only.*

The Proposal would require the Enterprises to calculate our RWA using both the standardized approach and the models-based advanced approach, with our risk-based capital requirements based on the higher of the RWA calculated under the two methodologies. In effect, FHFA has proposed to adopt the requirements of the Collins Floor.

The history of capital regulation of banking organizations is complex, with primary goals differing over time.[168] The Collins Floor, which requires that banking organizations not be subject to capital regulations that could yield lower capital requirements than the "generally applicable capital requirements," has a number of purposes, none of which is applicable to the Enterprises. First, the Collins Floor admonishes bank regulators not to create a capital framework that would have the effect of lowering capital requirements from those in effect just before the 2007–09 financial crisis. In the Proposal, FHFA has already incorporated

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164 *See* Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 84 Fed. Reg. 59,230 (Nov. 1, 2019) ("Capital and Liquidity Tailoring Rule").

165 *Id.*

166 *See* Basel Committee, *High-level summary of Basel III reforms* (Dec. 2017).

167 Capital and Liquidity Tailoring Rule at 59,249 (noting that the banking agencies are "considering how most appropriately to implement these standards in the United States, including potentially replacing the advanced approaches with risk-based capital requirements based on the revised Basel standardized approaches for credit risk and operational risk").

168 The domestic financial regulatory community also has not agreed with the U.S. 100% floor. The Basel Committee sharply diverged from the U.S. framework by adopting a final floor under Basel IV at 72.5%, to be phased in from 50% to 72.5% from 2022 to 2027. Basel Committee, *Finalising Basel III — In brief* (December 2017).

the base, statutory capital requirements applicable to the Enterprises,[169] in addition to the newly proposed supplemental risk-based measures. Second, the Collins Floor was intended to ensure that large, sophisticated institutions with resources to develop risk-based capital models were not treated more advantageously than banking organizations subject to the standardized or generally applicable framework. In the context of the Proposal, there are only two Enterprises, and each would be subject to the standardized approach set forth in the Proposal. Third, the Collins Floor also was intended to ensure that the capital requirements applicable to holding companies would be no different from, and no lower than, those applicable to their depository institution subsidiaries. This objective is not relevant in the context of the Enterprises.

VII. Operational Risk

A. *Freddie Mac supports a risk-based operational risk capital methodology.*

Consistent with our other comments on the Proposal, the operational risk methodology incorporated into a final capital framework should be risk-based, rather than a static percentage. To that end, we suggest that the Enterprises undertake a modeling approach based on internal loss data that is supplemented by scenario analyses for several additional risks, such as legal, fraud, financial reporting and technology risks. Our proposal would leverage the Loss Distribution Approach ("LDA") framework that incorporates internal loss data, augmented by use of scenario analysis add-ons, and would thereby reflect a risk-sensitive, future-looking view of operational risk.

While our approach is a models/scenarios-based approach, we would not recommend adopting the parametric-distribution method often used in the Advanced Measurement Approach ("AMA") employed under the bank capital advanced approach framework. Certain weaknesses and significant variability of the parametric-distribution model commonly used in the bank framework AMA have led bank regulators to revisit the use of this form of AMA, as we discuss further below. The LDA is an accepted form of AMA for operational risk, and use of the LDA, plus scenario analysis add-ons, would leverage our existing modeling framework, which we already use in our risk appetite calculations. On the other hand, we would also not recommend using the standardized measurement approach ("SMA"). The SMA is not as risk-sensitive, utilizing a financial statement-based proxy for operational risk and a scaling factor to calculate a static operational risk capital requirement based on a banking organization's size and past financial statement operational losses. The SMA does not reflect an organization's current risk profile.

B. *The loss confidence interval should be less than 99.9% to reduce volatility in potential outcomes, and therefore in capital requirements.*

We are in favor of a risk-based models approach. However, where the AMA has exhibited weakness is in the estimation of the extreme tail. Subjectivity, volatility and widely variable outcomes of those estimates across banking organizations have caused some to question the utility of the AMA, particularly with respect to the heightened variability in operational risk

[169] 12 U.S.C. § 4612.

calculations in the extreme tail.[170] In response to its mixed supervisory experience, the Basel Committee eliminated the AMA from the Basel Capital framework as part of the Basel IV reforms, and this development has been endorsed by the U.S. banking agencies.[171]

In order to address this weakness in transparency and clarity of the parametric-distribution model, we urge FHFA to accept a modification of the LDA 99.9% confidence interval for a one-year time horizon (essentially representative of "1-in-1,000 years" events). Because many types of operational risk occur infrequently and are not representative of potential future exposures, it is not meaningful to model to this level. Further, this extreme confidence interval is very sensitive to distributional assumptions; small changes in the probability of the occurrence of operational loss events could potentially lead to excessive capital requirements that do not align with an Enterprises' actual risk profile. A smaller confidence interval with an industry accepted distributional assumption would reduce this volatility, leading to more predictable capital requirements.

We recommend that the confidence interval for the operational risk modeling in the final rule be less than 99.9%. The formula could require a multiplier as necessary or appropriate for scaling. Freddie Mac is willing to work with FHFA to clarify the appropriate approach(es) for implementing the LDA and scenario analysis and to align the operational risk framework with the Enterprises' risk profile.

C. *The proposed operational risk capital floor should be reduced to 8 bps of ATA.*[172]

The Proposal's operational risk floor of 15 bps of ATA is too high, at almost double the current floor that FHFA maintains under the CCF and the static operational risk capital measure proposed under the 2018 Proposal. Similar to our comments on the leverage ratio, the risk-based capital floors and CRT floors, this floor is a static measure that should be calibrated primarily as a backstop to the risk-sensitive measurement approach described above.

The Proposal's 15 bps floor would not operate as a backstop. Under a number of industry- and supervisor-accepted models, our operational risk capital would be well below the floor, and therefore, the floor would be binding. Under (i) internal LDA (to a 99.9% confidence level) and using Federal Reserve guidance related to scenario analysis, (ii) analyses of Freddie Mac's largest historical, realized operational losses over a four-quarter period, using data collected since 2004 (including prior to conservatorship), (iii) stress-scenario losses through DFAST and (iv) the SMA net loss calculations/Basel Basic Indicator Approach, Freddie Mac's expected operational losses cluster around 7-9 bps of ATA, well below the Proposal's 15 bps

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170 *See* Basel Committee, *Consultative Document on Standardised Measurement Approach for Operational Risk* (March 2016); Marco Migueis, Federal Reserve Board, Evaluating the AMA and the New Standardized Approach for Operational Risk Capital at 6 (Apr. 9, 2018).

171 *See id.*; Basel Committee, *Basel III: Finalising Post-crisis Reforms* (Dec. 2017), at 128 et seq.; Press Release, Federal Reserve, FDIC, OCC, U.S. banking agencies support conclusion of reforms to international capital standards. (Dec. 7, 2017), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171207b.htm.

172 Fact Sheet, FHFA, FHFA Proposed Rule on Enterprise Capital (June 12, 2018), at tbl.1, https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Proposed-Rule-on-Enterprise-Capital.aspx.

floor. A binding floor would make irrelevant the use of any measurement approach, and would result in a static operational risk charge.

The bank capital framework's approach does not subject banking organizations to a separate operational risk minimum. Furthermore, even though it was non-risk-based, the 2018 Proposal set a fixed charge of 8 bps of ATA.[173] We understand that FHFA modified its proposal from 2018 because it would prefer that operational risk analysis and capital be risk-based rather than fixed. A binding floor would override the risk-sensitivity that FHFA is seeking.

A binding floor would serve as a disincentive to implementing risk-mitigating measures, including those derived from new technology and management information systems, as there would be no capital benefit to doing so. Given FHFA's move toward a more risk-based proposal for operational risk and our other recommendations in these comments that would further incent risk management, the level of the proposed floor is not necessary to accomplish FHFA's safety and soundness goals, and it should be reduced. An operational risk floor of 8 bps, similar to the fixed charge described in the 2018 Proposal, should be adopted.

VIII. Compliance Period

The Enterprises require a suitable transition period in which to raise capital to satisfy requirements under FHFA's proposed capital framework. A transition period is key to meeting a number of goals under the Proposal, including the Enterprises re-capitalizing, attracting investments from the private markets and having the opportunity to properly build and incorporate internal models and analyses, as needed.

To support these goals, we recommend that the final capital framework provide phase-in periods for the various capital requirements in the Proposal, provide sufficient time to build and implement internal models if the advanced approach is not eliminated and provide clarification on the resumption of capital classifications and associated restrictions on capital distributions during the transition period.

A. *The final capital framework should incorporate an appropriate phase-in period, beyond the effective date of any final rule, given the projections in the Proposal that the Enterprises would need to substantially increase our capital and provide acceptable returns in the form of distributions to investors.*

We share FHFA's and Treasury's goal of building capital from the private markets to support the Enterprises' exit from conservatorship. Clarity and certainty regarding the going-forward regulatory framework are critical to the success of the Enterprises' capital-raising efforts. The Proposal provides more certainty concerning final requirements, but it introduces new uncertainty concerning how the Enterprises will satisfy the new capital requirements introduced in the Proposal by its compliance date. A combination of substantially increased capital requirements for the Enterprises and the Enterprises' existing capital reserves

[173] 2018 Proposal at 33,333 (ATA approximates the base proposed in 2018).

would create a challenge for the Enterprises to adequately recapitalize by the specified compliance date.

As currently proposed, FHFA has provided two options for compliance with the Proposal's capital requirements. First, the compliance date could occur automatically as the later of one year from publication of the final rule or the date of an Enterprise's exit from conservatorship. At that point, full compliance with the minimum and buffer requirements would be expected. Alternatively, the Proposal would grant FHFA the discretion to create a "deferral period" for compliance with the capital requirements.[174] Nevertheless, during a deferral period, an Enterprise would be subject to capital restrictions—the Proposal would require that the Enterprise's PCCBA be equal to required CET1 capital plus required PCCBA and that the PLBA be equal to 4% of the Enterprise's ATA.[175] While this approach would effectively waive the capital requirements during the deferral period, an Enterprise still would be subject to restrictions on dividend distributions and executive compensation if the Enterprise has only achieved actual capital amounts within the buffer at the time of the deferral order.

This deferral buffer concept is not sufficiently flexible and does not provide a set runway for compliance. In order to provide a more certain path for the Enterprises to achieve compliance and more flexibility for actions along that path, we recommend the following:

- At the compliance date set forth in proposed § 1240.4(c) (the later of one year from publication of the final rule or the date of the Enterprise's exit from conservatorship), apply to the Enterprises a set of minimum risk-based ratios that are significantly lower than the Enterprise's fully phased-in amounts. This would allow the Enterprises to exit conservatorship with a smaller required capital amount, without being immediately out of compliance or subject to a buffer restriction.

- Phase in both the minima and the buffers over a five-year transition period where each of the minima and buffers would increase (*e.g.*, on January 1 of each year) to a new minimum and buffer amount established on a straight-line basis.

- Similar to the proposed ability to determine a deferral period, the final rule would have a "reservation of authority" provision that would allow FHFA to determine that any element of the phase-in schedule described above could be waived, postponed or accelerated with appropriate notice to the Enterprise.

    - If adjustments to executive compensation are necessary, they could be subject to separate agreements between FHFA and the Enterprise or addressed through FHFA's regulatory authority related to executive compensation.[176]

    - Payment of dividends and related distributions could be subject to certain extraordinary recapitalization requirements imposed if the Enterprise were to

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174 Proposal at 39,356.

175 *Id.*

176 *See* 12 C.F.R. pt. 1230.

exhibit weakness or an inability to achieve appropriate capital levels during the phase-in.

- While we do not believe that a corrective plan or a cease-and-desist order (as described in the proposed § 1240.4(d)(2)(iii)) is a necessary pre-requisite for exiting conservatorship, those tools, of course, would be available to FHFA.

Graduated phase-ins have been a significant feature of all material rulemakings by the banking agencies in relation to capital and the Basel framework.[177] The U.S. banking agencies implemented transition periods for each of the capital requirements in their final rule implementing the Basel Committee's Basel III reforms in 2013 over a period of five years.[178] Recently, the banking agencies implemented a three-year phase-in period for banking organizations for compliance with CECL,[179] and the Basel Committee introduced a five-year transition period to phase in requirements of Basel IV beginning in 2022 (both of which have been extended recently due to COVID-19).[180] Our recommended five-year phase-in period is similar to phase-in periods for complex capital requirements and would provide the Enterprises a suitable amount of time to reach full capitalization from private sources of capital without having to navigate either compliance failures or buffer restrictions.

The purpose of the phase-in would be to allow an Enterprise to build up its capital from a low level without immediately being subject to penalties on dividends and executive compensation. It is unlikely that the Enterprises could exit conservatorship in the near future at full capitalization. Private investors would have more confidence in supporting the Enterprises' capital-raising efforts if they understand that they are investing in attractive instruments issued

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177 *E.g.*, Regulatory Capital Rules: Regulatory Capital, Revisions to the Supplementary Leverage Ratio, 79 Fed. Reg. 57,725 (Sept. 26, 2014) (establishing a three-year phase-in period for the supplementary leverage ratio); Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions, 79 Fed. Reg. 24,528 (May 1, 2014) (establishing a three-year phase-in period for the eSLR); Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 Fed. Reg. 49,081 (Aug. 14, 2015) (establishing a three-year phase-in period for the G-SIB surcharge).

178 12 C.F.R. § 217.300(a) (establishing a five-year phase-in period for the capital conservation and countercyclical capital buffer); *see* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,017 (Oct. 11, 2013).

179 *See* Regulatory Capital Rule: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rule and Conforming Amendments to Other Regulations, 84 Fed. Reg. 4,222 (Feb. 14, 2019); Basel Committee, *High-level summary of Basel III reforms* (Dec. 2017).

180 Banking organizations were given the ability to further delay the implementation of CECL by two years, followed by a three-year transition period, due to the COVID-19 pandemic. *See* Regulatory Capital Rule: Revised Transition of the Current Expected Credit Losses Methodology for Allowances, 85 Fed. Reg. 17,723 (Mar. 31, 2020). Similarly, the Basel Committee deferred the beginning of the phase-in period for the Basel IV requirements by one year due to the COVID-19 pandemic. *See* Press Release, Basel Committee, Governors and Heads of Supervision announce deferral of Basel III implementation to increase operational capacity of banks and supervisors to respond to COVID-19 (Mar. 27, 2020), https://www.bis.org/press/p200327.htm.

by entities that are able to operate "business-as-usual" and will have the ability to provide returns and allow participation in the upside of the Enterprises' businesses. Therefore, to help the Enterprises reach full capitalization, the transition period should be structured to allow a gradual build-up of capital without restricting dividend payments on that issued capital. This would be similar to the phase-in of the Basel III reforms.

If FHFA were to retain the deferral and buffers concept rather than phasing in the minimum and buffer requirements over time, dividend restrictions should be waived in any deferral order, unless the Enterprise evidences weakness or is at risk of not exiting the deferral period fully capitalized. This would be necessary to attract investors. As another alternative, the deferral order could make the buffers more flexible by phasing in the "top" of the buffer over a period of time. For example, CET1 plus PCCBA could begin at a lower number and gradually phase in to reach the maximum.

B. *If the advanced approach is adopted, the final capital framework should provide a sufficiently long runway to develop and implement the requisite internal models.*

Building internal models to implement the advanced approach has proven to be a significant undertaking based on the past experiences of banking organizations subject to the advanced approaches. Upon the introduction of the advanced approaches in Basel II, large banking organizations spent several years and hundreds of millions of dollars to build and gain regulatory approval for their internal models.

In Subsection VI.A we recommend that the advanced approach not be adopted. In addition, we note that the grids, multipliers and overall analyses in the standardized approach were developed through consultation between the Enterprises and FHFA and are already based on internal models. It is not realistic for the Enterprises to build and gain regulatory approval for a second, separate set of internal models by the Proposal's compliance date. In conjunction with the phase-in periods for other requirements in the Proposal, if the advanced approach is adopted, we believe the Enterprises would need an extended timeline to build and gain regulatory approval for any new internal models. In addition, during that period the Enterprises should be required to comply only with the risk-based standardized approach.

C. *The final capital framework should clarify the timing of resumed capital classifications for the Enterprises and the extent to which any classification-related restrictions on capital distributions or other actions would apply during any phase-in period while the Enterprises are raising capital.*

A statutory capital classifications scheme for government-sponsored enterprises exists at 12 U.S.C. § 4614, containing four capital classifications—adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized—with associated enforcement tools for each classification. However, FHFA suspended capital classification of the Enterprises and application of the Office of Federal Housing Enterprise Oversight's PCA framework it inherited when it placed the Enterprises in conservatorship in 2008. Since that time, FHFA has not adopted a new capital classifications scheme or PCA framework for the Enterprises. A fully developed capital classifications scheme and PCA framework for the Enterprises would both supplement FHFA's available supervisory actions for times when the

Enterprises may not be adequately capitalized and provide certainty to the Enterprises as to when we may be subject to intervention by FHFA. As FHFA finalizes the proposed capital framework for the Enterprises, the Enterprises will need clarity about the resumption of capital classifications and restrictions on capital distributions under a PCA framework that would apply during any transition period.

APPENDICES

A. Risk-based Capital: Floors

Appendix A.1. Risk Differentiation by FICO and LTV Segments

The floor impairs the risk sensitivity of the capital framework because of the material difference between a floor calibrated at 120 bps and the dispersion of loans that are subject to the floor across a wide range of observed risk significantly lower than 120 bps.

Post-MI 2007 Qualified Mortgage Portfolio – Cumulative Loss in bps:

FICO/LTV	<=30%	(30%, 60%]	(60%, 70%]	(70%, 75%]	(75%, 80%]	(80%, 85%]	(85%, 90%]	(90%, 95%]	(95%, 100%]	>100%
<620	38.58	169.76	397.72	577.53	697.61	856.46	973.15	1,213.59	1,353.45	1,598.03
[620, 640)	19.59	131.61	319.39	424.95	543.65	647.13	782.45	1,079.42	1,211.99	1,342.12
[640, 660)	17.77	110.29	268.23	382.36	464.33	580.83	714.76	968.09	1,183.53	1,264.93
[660, 680)	10.66	77.57	209.79	308.44	408.02	508.53	609.60	918.87	1,120.05	1,151.11
[680, 700)	8.49	55.39	167.42	257.92	338.57	429.22	520.65	810.67	1,082.38	1,060.67
[700, 720)	3.96	37.84	128.26	202.42	273.32	350.26	433.74	728.02	1,016.67	974.44
[720, 740)	3.01	28.21	97.71	164.18	215.21	293.17	358.85	633.87	902.01	894.28
[740, 760)	2.04	18.08	68.97	116.25	165.81	226.42	273.38	514.94	782.84	778.72
[760, 780)	0.93	10.70	47.34	86.68	123.37	166.03	199.17	416.11	650.18	664.13
>=780	0.71	8.63	34.56	61.16	89.79	129.10	149.77	332.25	513.60	519.68

Blue shading represents FICO/LTV segments with capital requirements lower than the 120 bps proposed floor

Post-MI 2007 Total Portfolio – Cumulative Loss in bps:

FICO/LTV	<=30%	(30%, 60%]	(60%, 70%]	(70%, 75%]	(75%, 80%]	(80%, 85%]	(85%, 90%]	(90%, 95%]	(95%, 100%]	>100%
<620	37.56	167.69	406.95	599.42	746.48	932.17	1,128.93	1,436.16	1,776.69	1,829.31
[620, 640)	20.54	131.66	325.88	456.36	589.54	748.45	964.08	1,311.76	1,698.43	1,617.18
[640, 660)	17.85	111.14	280.76	415.27	532.12	686.27	913.77	1,261.89	1,721.60	1,626.43
[660, 680)	11.40	79.74	224.39	343.03	469.29	621.52	815.38	1,215.97	1,725.39	1,628.68
[680, 700)	9.10	57.75	180.95	291.60	404.12	549.52	711.56	1,131.90	1,677.89	1,635.36
[700, 720)	4.09	40.15	141.10	238.33	337.71	455.25	626.96	1,014.79	1,585.88	1,586.98
[720, 740)	3.02	29.59	109.50	192.46	276.41	394.98	525.99	906.33	1,471.25	1,506.21
[740, 760)	2.00	19.57	77.14	140.37	215.03	308.51	399.01	744.18	1,281.63	1,353.03
[760, 780)	1.08	11.48	54.21	104.84	157.12	223.21	293.51	571.91	1,037.25	1,141.27
>=780	0.73	8.99	39.09	74.88	109.89	161.98	204.06	444.32	769.18	863.02

Blue shading represents FICO/LTV segments with capital requirements lower than the 120 bps proposed floor

B. Risk-based Capital: Grids & Multipliers

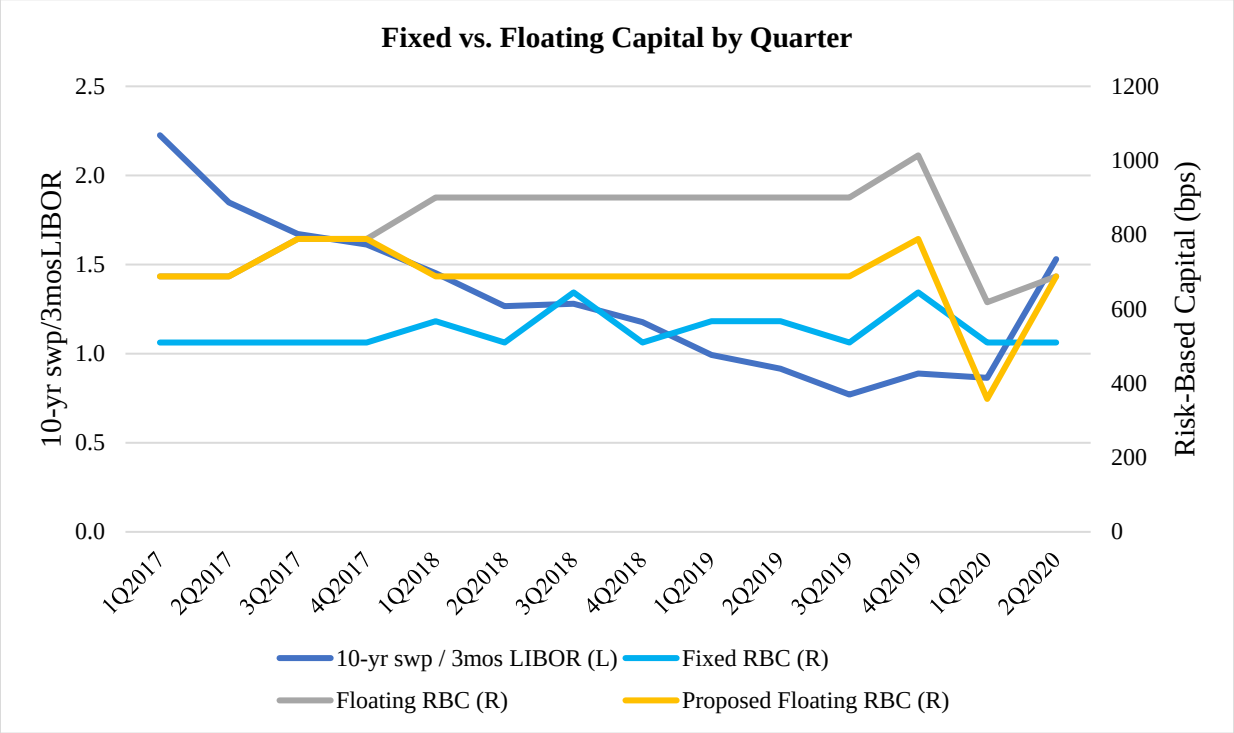
Appendix B.1. Single Family Examination of the 30 – 60 LTV Band

The single-family look-up tables should be modified to split the 30-60% LTV band into three segments (30-40%, 40-50% and 50-60%) to increase risk-sensitivity.

Proposed Rule		LTV Analysis		
LTV Range (%)	**Capital for 2019Q3 QM Portfolio (bps)**	**LTV Range (%)**	**Actual Loss for 2007Q4 QM Portfolio (bps)**	**Proposed LTV Grouping (%)**
(00-30]	14	(00-30]	5	(00-30]
(30-60]	53	(30-35]	10	(30-40]
		(35-40]	15	
		(40-45]	21	(40-50]
		(45-50]	33	
		(50-55]	46	(50-60]
		(55-60]	72	
(60-70]	170	(60-70]	125	(60-70]

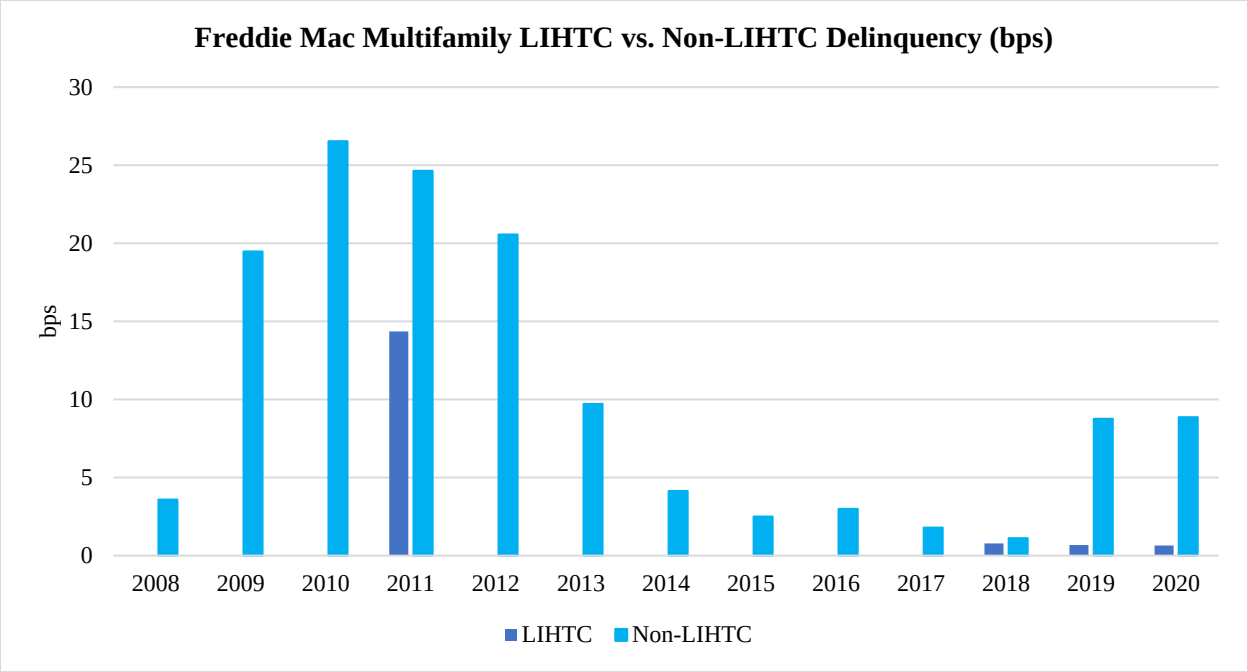
Appendix B.2. Multifamily Floating Rate Grids

We recommend that FHFA retain the current look-up table, but place multifamily ARM loans into a lower DSCR band when interest rates are falling. This approach would provide appropriate capital treatment for multifamily ARMs in periods when the yield curve is inverted or flat. This approach would reduce the disparity in capital treatment for multifamily ARMs in periods when the yield curve is inverted or flat, which would make the capital framework more dynamic and risk-sensitive overall by promoting comparable treatment of comparable credit risks.



Appendix B.3. Multifamily LIHTC Multiplier

We recommend that FHFA add a 0.60 multiplier for exposures to multifamily properties that are funded through LIHTCs, which are the main source of new affordable rental housing construction in the United States. These loans tend to perform particularly well due to strong commitment from local governments and housing authorities to the acquisition, rehabilitation, or new construction of rental housing targeted to lower-income households. Governments encourage the use of the LIHTC program to fund these projects.



Non-LIHTC includes whole loans, credit enhanced bonds, PassThru certificate swaps, tax exempt bond securitizations, and securitized loans.

Delinquency is defined as 60 days+ including foreclosure

C. Risk-based Capital: Countercyclical Adjustment

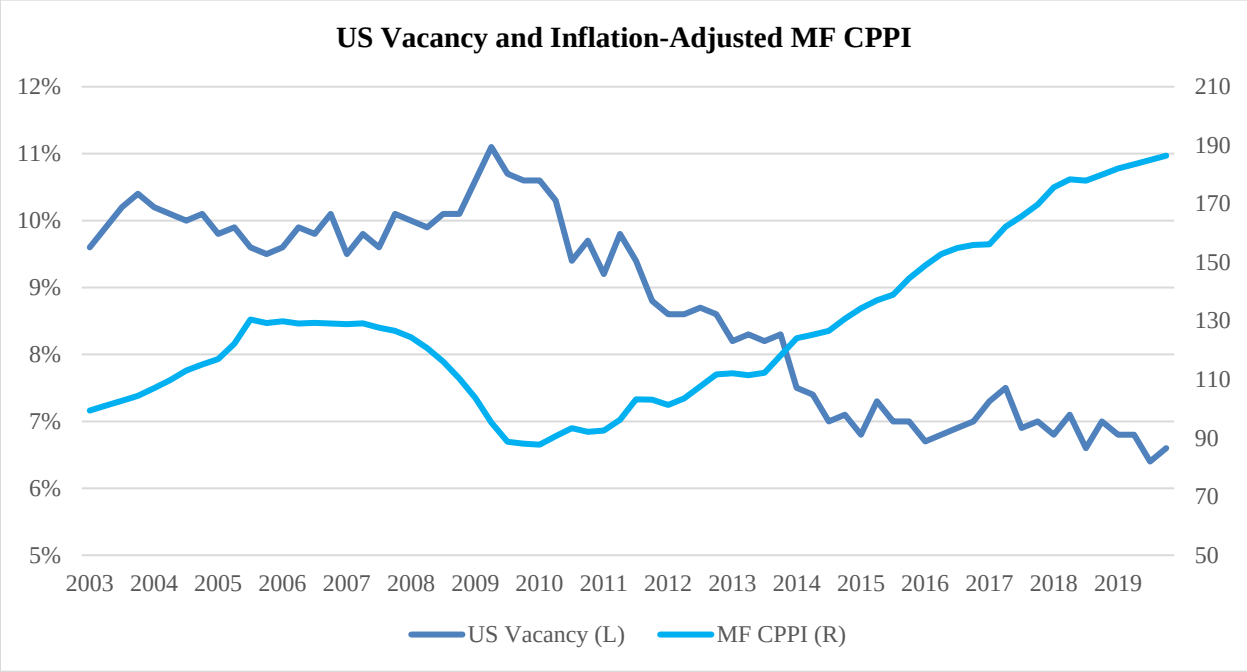
Appendix C.1. Single Family Historical HPI Changes

There is an additional level of conservatism embedded through the countercyclical LTV combined with the base grids already assuming 25% HPI drop resulting in the combined stress being higher than the actual stress across different time periods.

	Timing		Countercyclical LTV		Effective Stress			
			LTV	Adjusted LTV	LTV Effect	Grid Stress	Combined Stress	Actual Stress
1	Peak Actual	2007Q1	80%	94%	-15%	-25%	-36%	**-19%**
2	Crossed Trend	2009Q3	80%	80%	0%	-25%	-25%	**-7%**
3	Trough Actual	2012Q2	80%	69%	16%	-25%	-13%	**0%**
4	Current	2020Q1	80%	80%	0%	-25%	-25%	n.a.

Appendix C.2. Multifamily Countercyclical Adjustment

We suggest that a multifamily countercyclical adjustment be designed using long-term vacancy rates, based on their negative correlation with multifamily home pricing. We recommend the adjustment be applied when realized long-term vacancy rates fall outside a prescribed band of 6-9%.



Assume we have a long-term vacancy band [6%, 9%], if the realized vacancy (V) falls into this band, we do not have any adjustment.

If V<6% (a better than normal market condition), the adjustment (%) = (6%-V)/6%;

If V>9% (a worse than normal market condition), the adjustment (%) = (V-9%)/9%;

The adjustment, which is capped at 30%, will be split at a 25/75 scale to the two dimensions of the grid - DSCR and LTV.

Adjusted DSCR = DSCR * (1+ adjustment*25%)

Adjusted LTV = LTV / (1 + adjustment*75%)

At critical points in time, the adjustment is illustrated here:

	January 1, 1982	January 1, 2008	January 1, 2019
Real Vacancy	5.3	10.1	7
Low band	6	6	6
High band	9	9	9
Counter-cyclical Adjustment	-12%	12%	0%

Adjusted MTMLTV = MTMLTV/(1+75%*Counter-cyclical Adjustment)

		Adjusted MTMLTV		
		January 1, 1982	January 1, 2008	January 1, 2019
MTMLTV	60%	66%	55%	60%
	80%	88%	73%	80%
	95%	104%	87%	95%

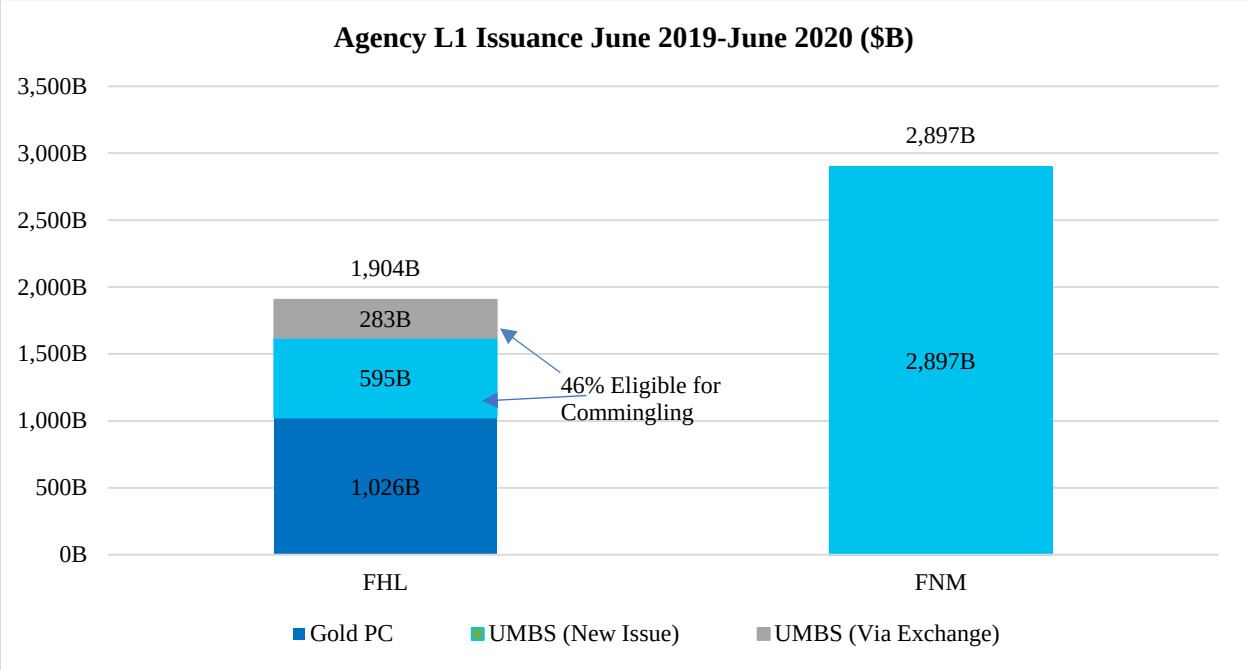
Adjusted DSCR = DSCR*(1+25%*Counter-cyclical Adjustment)

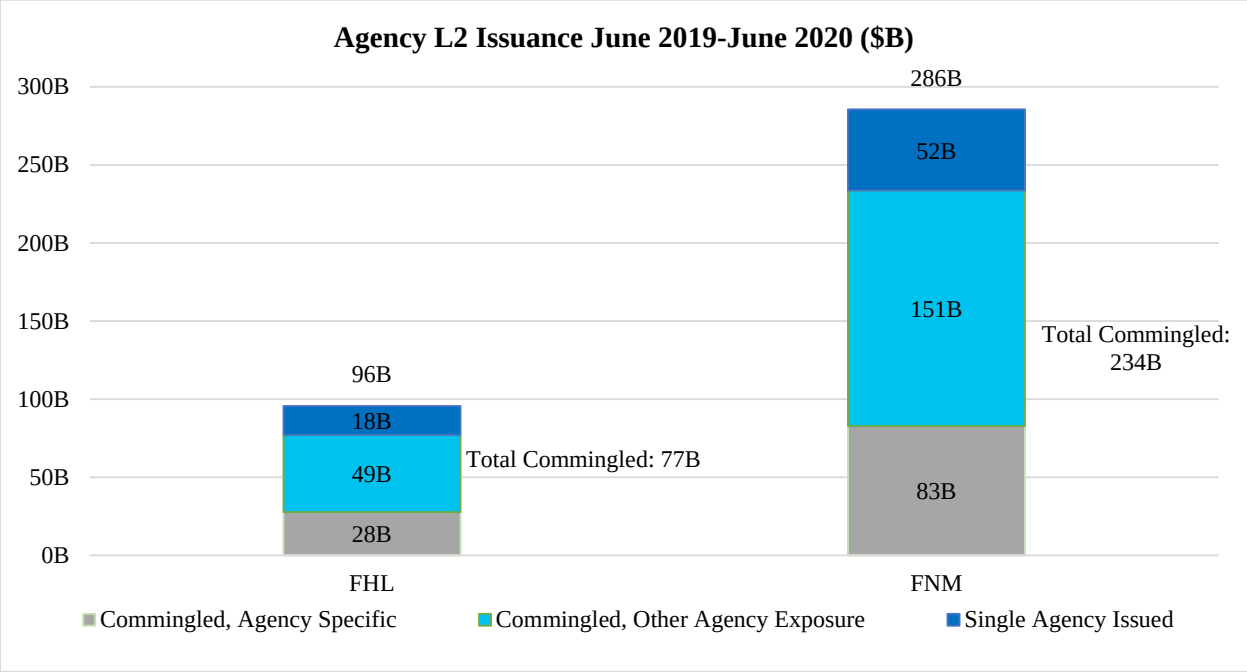
		Adjusted DSCR		
		January 1, 1982	January 1, 2008	January 1, 2019
DSCR	1.60	1.55	1.65	1.60
	1.40	1.36	1.44	1.40
	1.20	1.17	1.24	1.20

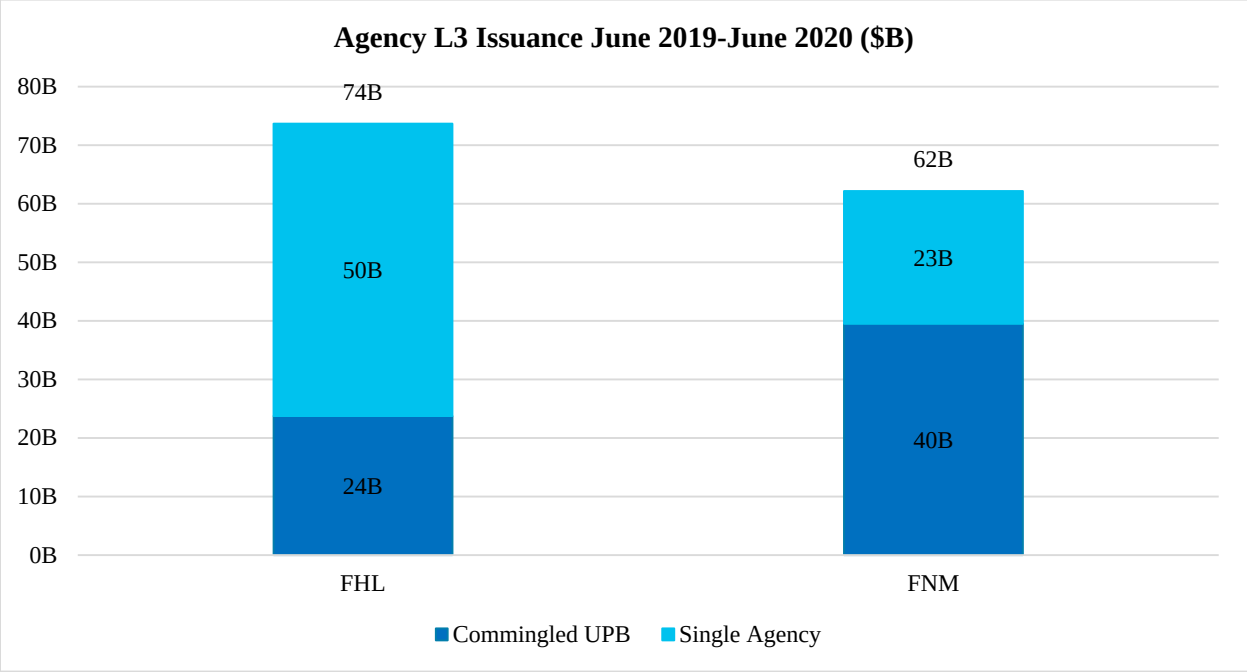
D. Risk-based Capital: UMBS Commingled Securities & Crossholdings

Appendix D.1. Outstanding Supply of Fannie Mae and Freddie Mac UMBS Securities

At the encouragement of FHFA, Freddie Mac lowered our resecuritization fees for UMBS in order to produce fungibility off the single security platform, and because a portion of each resecuritization is a commingling containing an embedded guarantee from Fannie Mae. If each Enterprise is appropriately capitalized in relation to its risks and exposures, there should be no need for the Enterprises to re-capitalize for each other.




Agency L2 Issuance June 2019-June 2020 ($B)
300B
250B
200B
150B
100B
50B
0B
96B
18B
49B
28B
Total Commingled: 77B
286B
52B
151B
83B
Total Commingled: 234B
FHL
FNM
Commingled, Agency Specific
Commingled, Other Agency Exposure
Single Agency Issued


Agency L3 Issuance June 2019-June 2020 ($B)
80B
70B
60B
50B
40B
30B
20B
10B
0B
74B
50B
24B
62B
23B
40B
FHL
FNM
Commingled UPB
Single Agency

E. CRT Benefits

Appendix E.1. Mechanics of CRT Capital Relief calculations under Freddie Mac's proposal to introduce 25% Capital Benefit Haircut and replace proposed CRTA 10% prudential floor and 10% OEA adjustment

The 25% Capital Benefit Haircut recommendation, discussed in the Subsection III.B.1, to FHFA's CRTA proposal will result in the following changes to the mechanics of post CRT RWA calculations:

Risk Weight (RW%) assigned to a retained CRT exposure, or portion of a retained CRT will be calculated as follows.

1. When the detachment point, parameter D, for a retained CRT exposure is less than Lower Bound (LB), the tranche will be assigned a risk weight of 1,250 percent.

2. When the detachment point, parameter D, for a retained CRT exposure is greater than or equal to Lower Bound (LB), the risk weight is calculated by adding three components depending on position of LB, SDC and UB relative to the tranche

$$RW_{\%,\,Tranche} = \begin{cases} 1{,}250\% \; if \; D < LB \\ \{Max[(LB - A) / (D - A) * 1{,}250\%, 0] * 100\%\} + \{Max[(Min(SDC, D) - Max(LB, A)) / (D - A) * 1{,}250\%, 0] * 75\%\} + \{Max[(Min(UB, D) - Max(SDC, A)) / (D - A) * 1{,}250\%, 0] * 25\%\} \; if \; D \geq LB \end{cases}$$

where, A = Layer Attachment, D = Layer Detachment, SDC = (K + EL), Lower Bound (LB) = SDC * 75%, and Upper Bound (UB) = SDC * 1.25%

Loss Sharing Effectiveness Adjustment (LSEA) and Loss Timing Effectiveness Adjustment (LTEA) calculation remains unchanged from the CRTA.

Enterprise Adjusted Exposure (EAE) calculation will be calculated as in proposed CRTA except no OEA adjustment will be applied (*i.e.*, OEA=100%), except for to certain complex/non-standard structures.

Adjusted Exposure Amount (AEA) calculation, Post-CRT RWA by Tranche calculation, and finally Post-CRT RWA and Capital Relief calculation remains unchanged from the CRTA, except when $RW_{\%,\,Tranche} = 0$, $AEA_{\$,Tranche}$ will be calculated as $EAE_{\%Tranche} * AggUPB_{\$} * (D - A)$.

Example of post CRT RWA calculations for an illustrative DNA2 deal

Illustration below provides step by step CRT Capital Relief calculation for stylized DNA CRT structure (i.e. low LTV SF mortgage exposure).
The deal has following parameter values:

- $1,000,000,000 (AggUPB$) in unpaid principal balance of performing 30-year fixed rate SF mortgage exposures with OLTVs greater than 60% and less than or equal 80%;

- CRT capital markets coverage term of 30 years;
- Three tranches BH, M1 and AH with attachment points of 0%, 0.5% and 2.6% respectively;
- Freddie Mac retains 100% of AH and BH tranches, and ownership of M1 tranche is split between capital markets (60%), reinsures (35%), and Freddie Mac (5%);
- Aggregate expected losses on the SF mortgage exposure underlying the CRT of 0.2% (AggEL%), and aggregated stressed losses of 2.4% (KA); and
- Aggregate credit risk-weighted assets on the SF mortgage exposures underlying the CRT are $300,000,000 (RWA$).

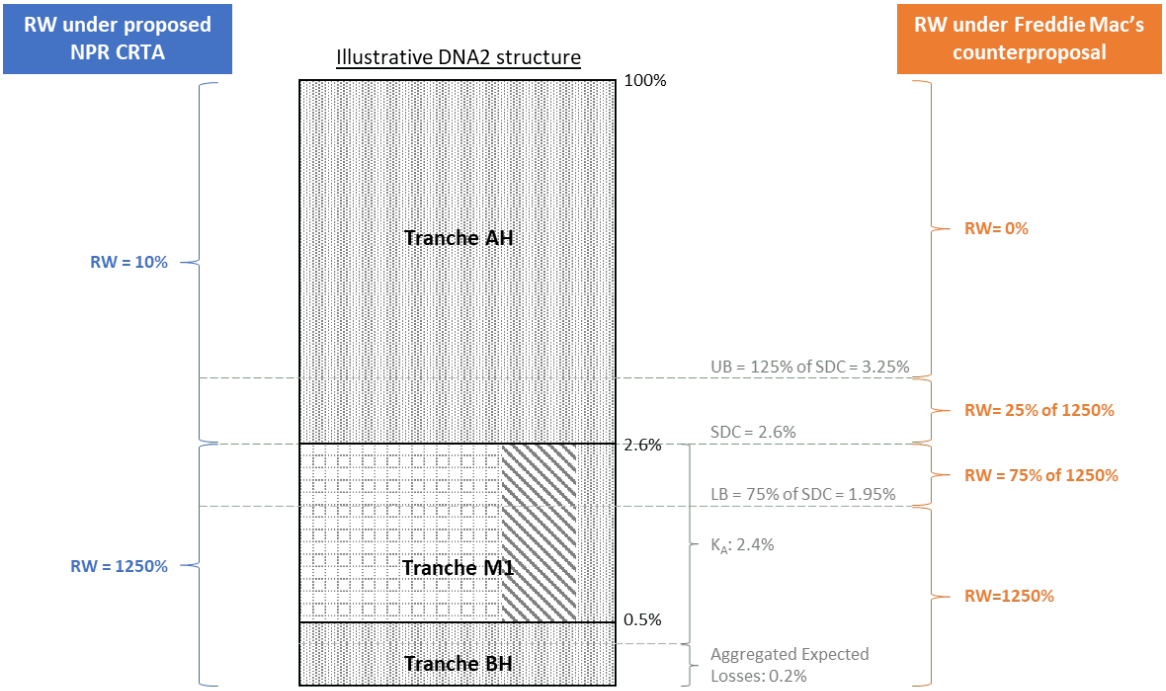


Figure 1: Risk weight assignment under Freddie Mac's proposal to replace FHFA's 10% prudential floor and 10% OEA adjustment with 25% Capital Benefit Haircut

Step 1: RW assignment

The risk weights for tranches AH, M1, and BH are calculated as follows:

$RW_{\%,AH}$ = (UB - SDC) / (D – A) * 1,250%* 25%

= (3.25% - 2.6%) / (100% - 2.6%) * 1,250%* 25%

= 2.1%, because (KA + AggEL%)*1.25% [UB] > 2.6%

$RW_{\%,M1}$ = (SDC – LB) / (D – A) * 1,250% * 75% + (LB - A) / (D – A) * 1,250%

= (2.6% – 1.95%) / (2.6% - 0.5%) * 1,250%* 75% + (1.95% - 0.5%) / (2.6% - 0.5%) * 1,250%

= 1,153%, because (KA + AggEL%)*1.25% [UB] < 2.6% and (KA + AggEL%)*75% [LB] > 0.5%

$RW_{\%,BH}$ = 1,250%, because (KA + AggEL%)*75% [LB] > 0.5%

Step 2: Enterprise Adjusted Exposure (EAE) calculation

$EAE_{\%,Tranche}$ is calculated as in CRTA except no OEA adjustment is applied (*i.e.*, OEA=100%) since DNA structure is very typical, non-complex CRT structure.

$EAE_{\%,AH}$ = 100% ; $EAE_{\%,M1}$ = 10%; $EAE_{\%,BH}$ = 100%.

Step 3: Adjusted Exposure Amount (AEA) calculation

$AEA_{\$,Tranche}$ is calculated as in CRTA, where:

$AEA_{\$,AH}$ = $974,000,000 ; $AEA_{\$,M1}$ = $2,053,550; and $AEA_{\$,BH}$ = $3,000,000.

Step 4: Post-CRT RWA by Tranche calculation

As under CRTA, $RWA_{\$,Tranche}$ is calculated by multiplying $RW_{\%,Tranche}$ with $AEA_{\$,Tranche}$ for each tranche:

$RWA_{\$,AH}$ = $20,312,500; $RWA_{\$,M1}$ = $23,683,060; and $RWA_{\$,BH}$ = $37,500,000.

Step 5: Post-CRT RWA and Capital Relief calculation

As under CRTA, Post-CRT RWA is calculated by aggregating RWA for all tranches as calculated in step 4 to get to Post-CRT RWA of $81,495,560. Similarly, Post-CRT RWA is deducted from Pre-CRT RWA to get to RWA Relief of $218,504,440.

Appendix E.2. Impact analysis of Freddie Mac's proposed approach on example DNA deal

The Proposal imposes significantly higher capital requirements when compared to 2018 CCF and does not permit capital relief for purchases of greater protection. Our proposal would incentivize Freddie Mac to sell at a higher detachment point to receive higher capital relief.

DNA [D = 2.6%]	With Buffers & Operational Adjustments			Without Buffers & Operational Adjustments		
	Pre-CRT	**Post CRT**	**Relief (%)**	**Pre-CRT**	**Post CRT**	**Relief (%)**
2018 CCF	357	129	64%	274	46	83%
CRTA	394	301	24%	240	147	39%
Freddie Mac Proposed Framework	394	219	44%	240	65	73%

Pre CRT RWA ($)	$ 300,000,000
CRTA Post-RWA ($)	$ 183,893,738
Freddie Mac Proposed Capital Framework Post-CRT RWA ($)	$ 81,495,560

As noted below, when Freddie Mac will increase M1 detachment point for this example DNA deal from 2.6% to 4.5%, we will be able to decrease our RWA for this deal by over $20 million and increase our Capital Relief from 73% to 80% (when not considering buffers and operational risk add-ons).

DNA [D = 4.5%]	With Buffers & Operational Adjustments			Without Buffers & Operational Adjustments		
	Pre-CRT	**Post CRT**	**Relief (%)**	**Pre-CRT**	**Post CRT**	**Relief (%)**
2018 CCF	357	129	64%	274	46	83%
CRTA	394	299	24%	240	145	40%
Freddie Mac Proposed Framework	394	203	48%	240	49	80%

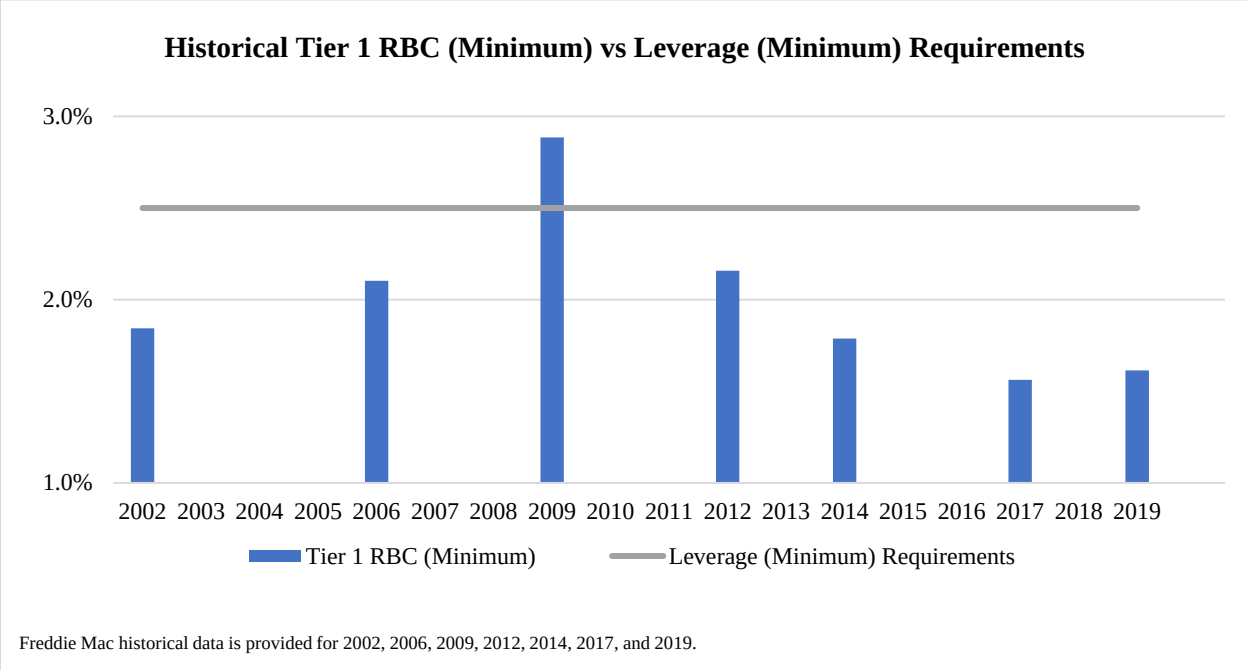
Pre CRT RWA ($)	$ 300,000,000
CRTA Post-RWA ($)	$ 180,745,166
Freddie Mac Proposed Capital Framework Post-CRT RWA ($)	$ 61,337,656

Finally, even when we increase our detachment point, our maximum capital relief will not exceed 50% considering buffers and operational risk add-ons, which is still a very conservative approach.

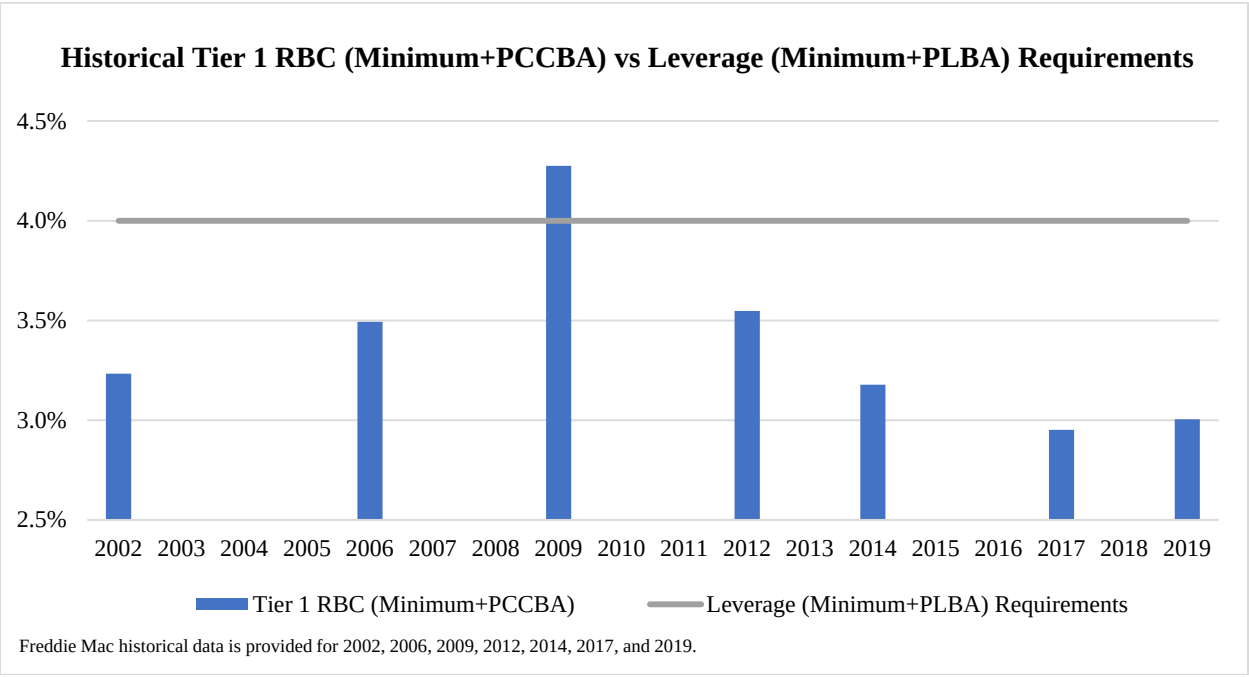
F. Leverage Capital Requirements

Appendix F.1. Historical Freddie Mac Risk-Based Capital to Leverage requirements

Looking back over the past 18 years, Freddie Mac estimates that the proposed leverage requirements would have been binding for Freddie Mac in all but two or three years at the peak and end of the previous financial crisis, when compared to the Proposal's Tier 1 risk-based capital requirement (adjusted in each year for credit products currently permissible for our portfolio).



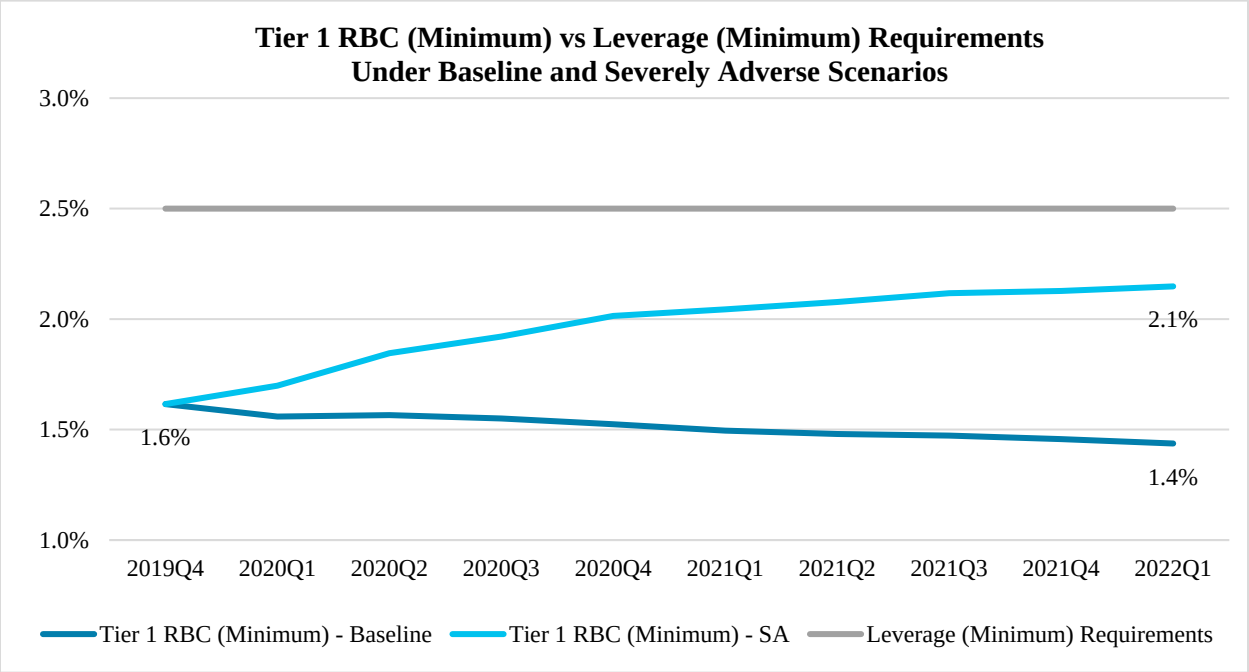
Freddie Mac historical data is provided for 2002, 2006, 2009, 2012, 2014, 2017, and 2019.

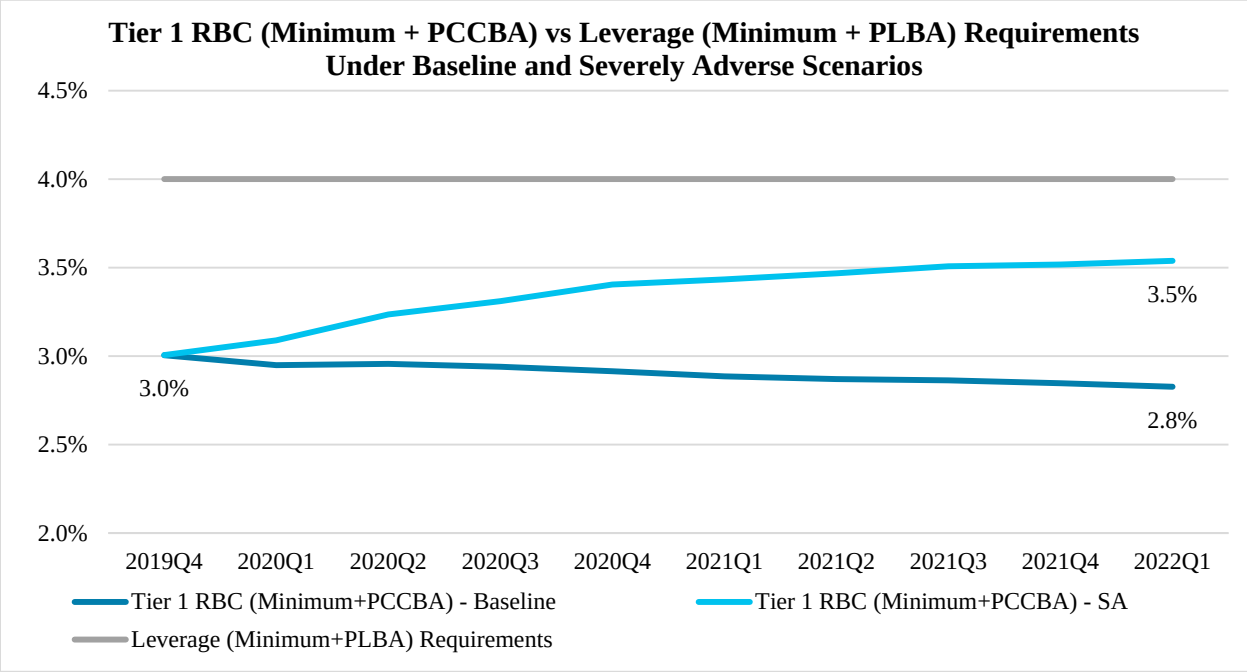


Freddie Mac historical data is provided for 2002, 2006, 2009, 2012, 2014, 2017, and 2019.

Appendix F.2. Freddie Mac Tier 1 RBC vs Leverage Requirements under Baseline and Severely Adverse Scenarios

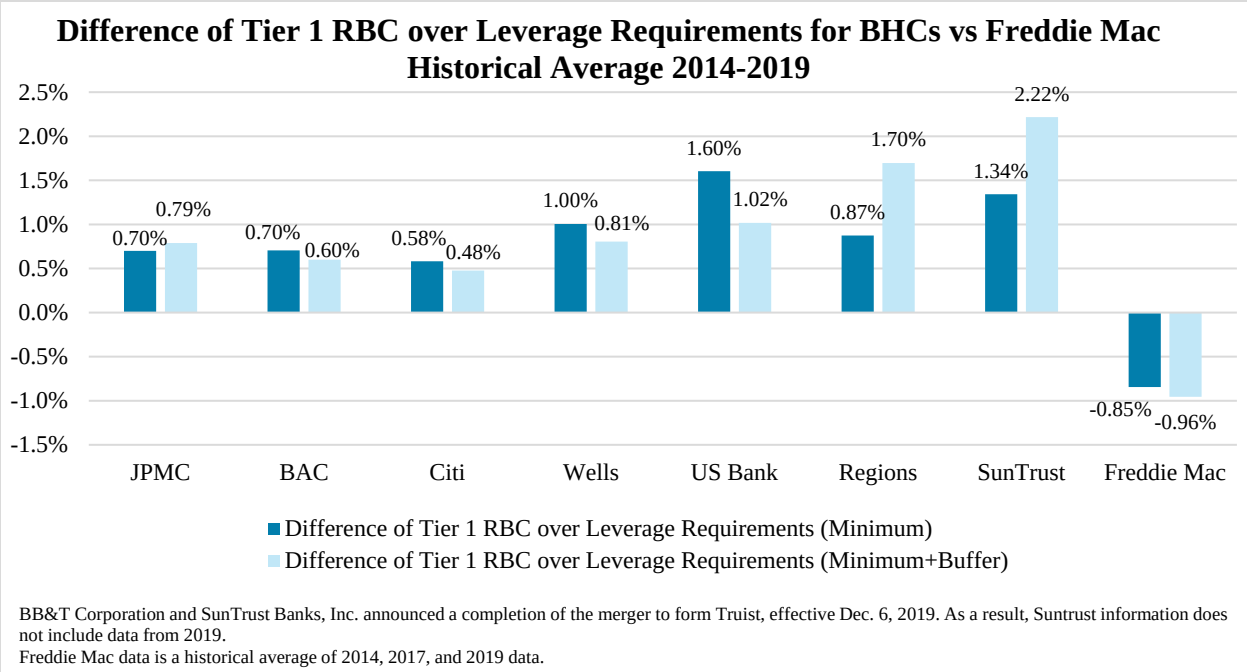
Looking forward, the leverage measurement would also be the binding constraint on Tier 1 capital in every quarter of a nine-quarter stress horizon under a severely adverse stress scenario.




Tier 1 RBC (Minimum + PCCBA) vs Leverage (Minimum + PLBA) Requirements
Under Baseline and Severely Adverse Scenarios
4.5%
4.0%
3.5%
3.0%
2.5%
2.0%
3.5%
3.0%
2.8%
2019Q4
2020Q1
2020Q2
2020Q3
2020Q4
2021Q1
2021Q2
2021Q3
2021Q4
2022Q1
Tier 1 RBC (Minimum+PCCBA) - Baseline
Tier 1 RBC (Minimum+PCCBA) - SA
Leverage (Minimum+PLBA) Requirements

Appendix F.3. Difference of Tier 1 RBC over Leverage Requirements for BHCs and Freddie Mac

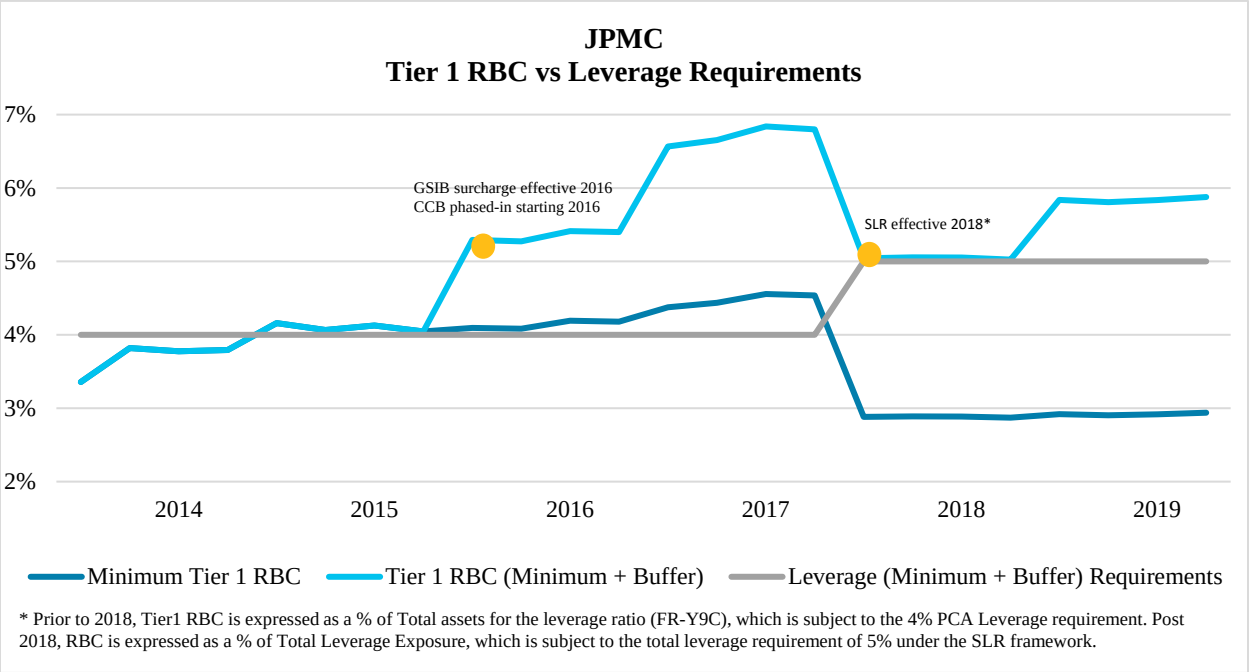
When normalized for a denominator of total leverage exposure (or ATA), the capital requirements for U.S. commercial bank G-SIBs and selected regional banks exhibits a positive difference of the Tier 1 risk-based ratio requirements over their leverage ratio requirements (both with and without the SLR buffer). The opposite occurs in relation to an analysis of the Proposal's Tier 1 risk-based ratio relative to the Proposal's leverage ratio, thus indicating inappropriate calibration for the overall risk profile of Freddie Mac.



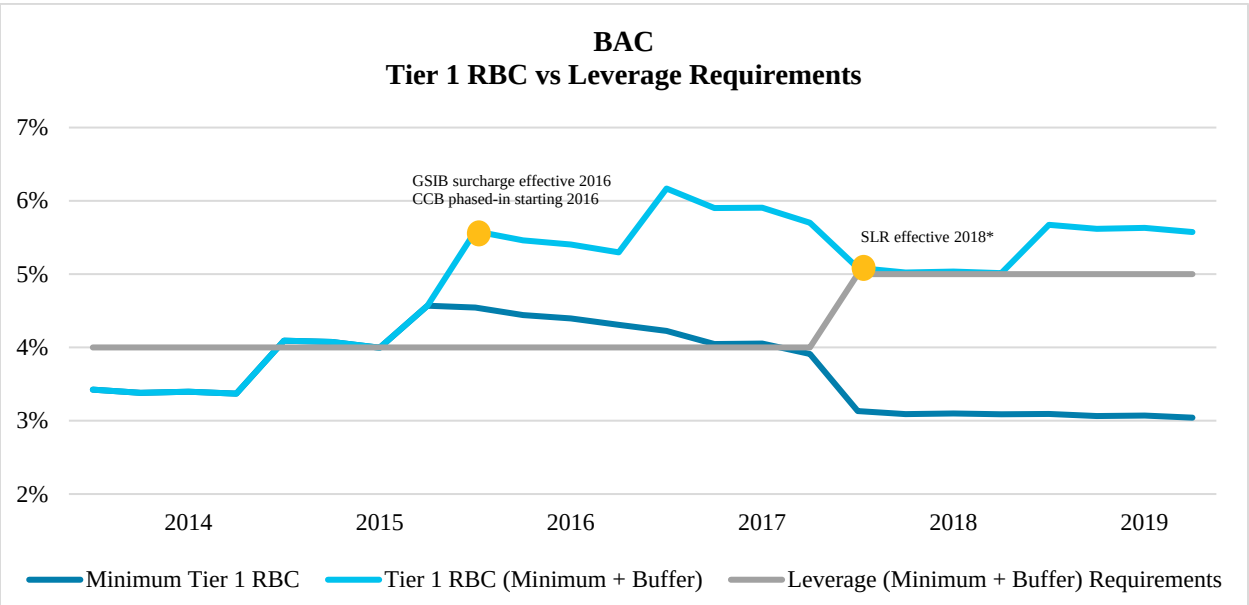
BB&T Corporation and SunTrust Banks, Inc. announced a completion of the merger to form Truist, effective Dec. 6, 2019. As a result, Suntrust information does not include data from 2019.
Freddie Mac data is a historical average of 2014, 2017, and 2019 data.

Appendix F.4. Historical BHCs Risk-Based Capital vs Leverage requirements

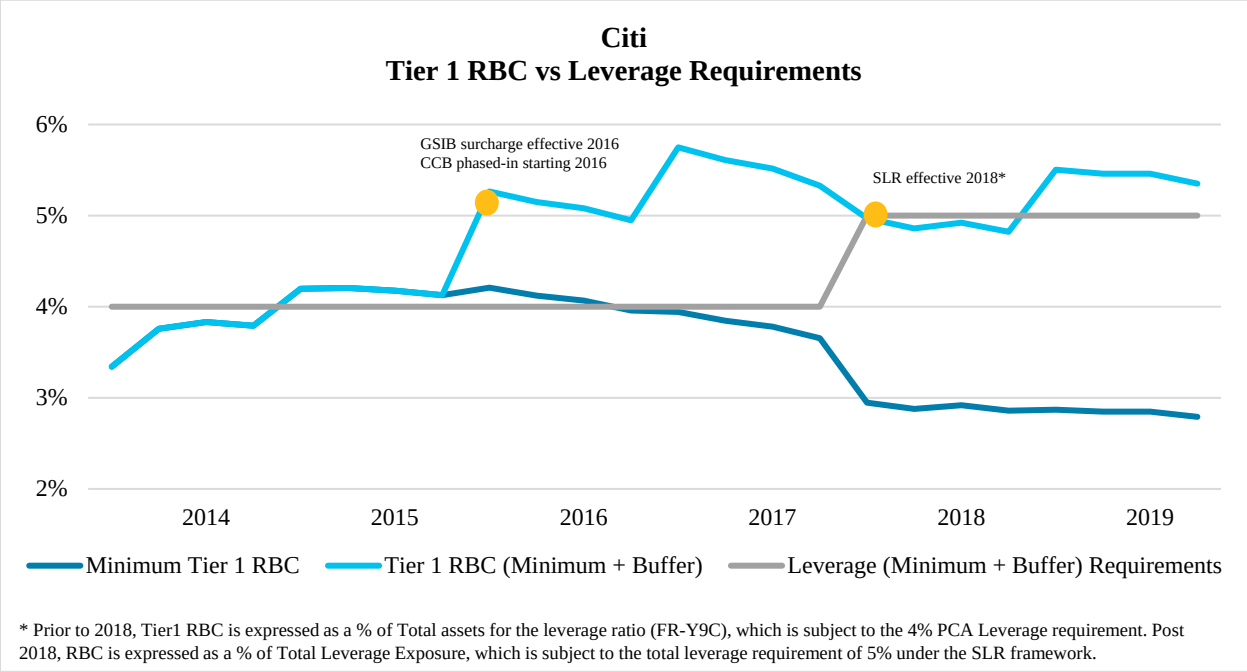
As shown below, the bank capital framework's SLR has not been a materially binding constraint for the U.S. commercial bank G-SIBs between 2014 and 2019, even taking into account the 2% eSLR buffer.



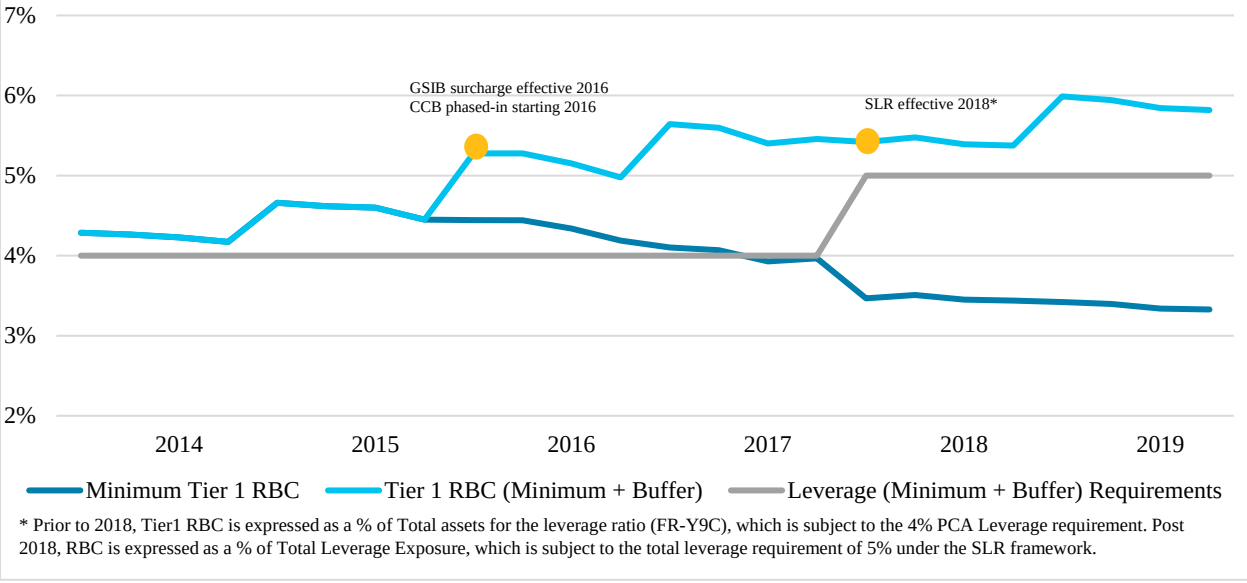
* Prior to 2018, Tier1 RBC is expressed as a % of Total assets for the leverage ratio (FR-Y9C), which is subject to the 4% PCA Leverage requirement. Post 2018, RBC is expressed as a % of Total Leverage Exposure, which is subject to the total leverage requirement of 5% under the SLR framework.



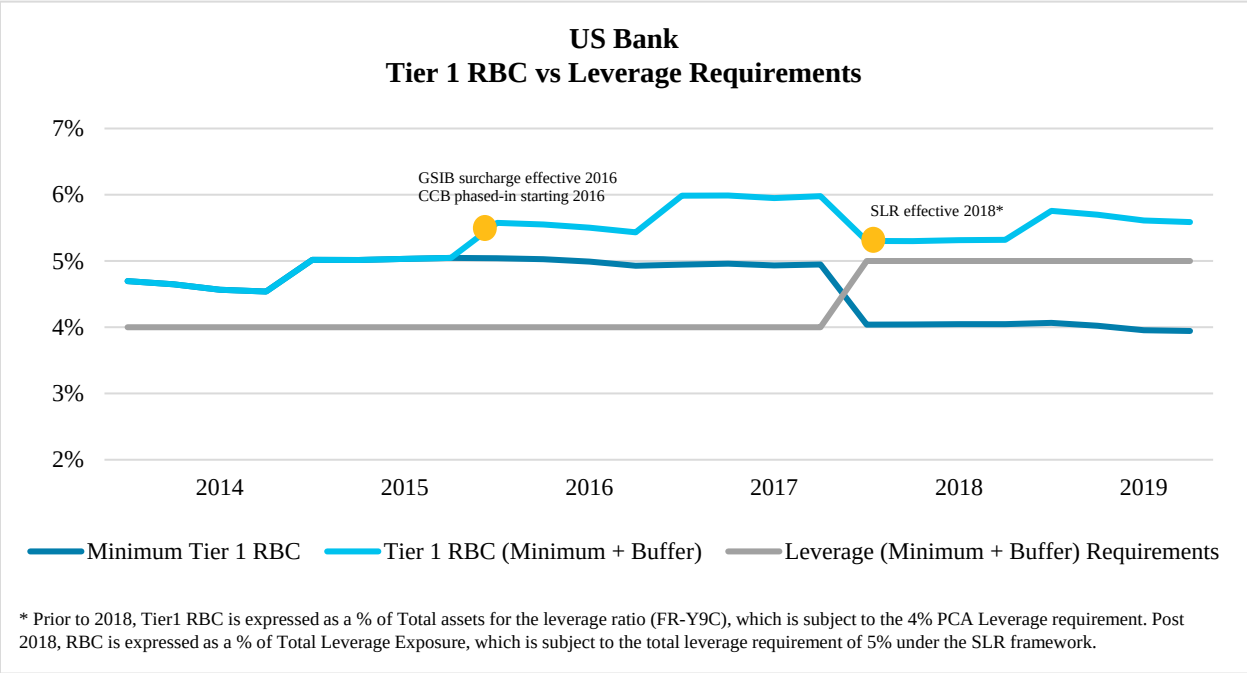
* Prior to 2018, Tier1 RBC is expressed as a % of Total assets for the leverage ratio (FR-Y9C), which is subject to the 4% PCA Leverage requirement. Post 2018, RBC is expressed as a % of Total Leverage Exposure, which is subject to the total leverage requirement of 5% under the SLR framework.



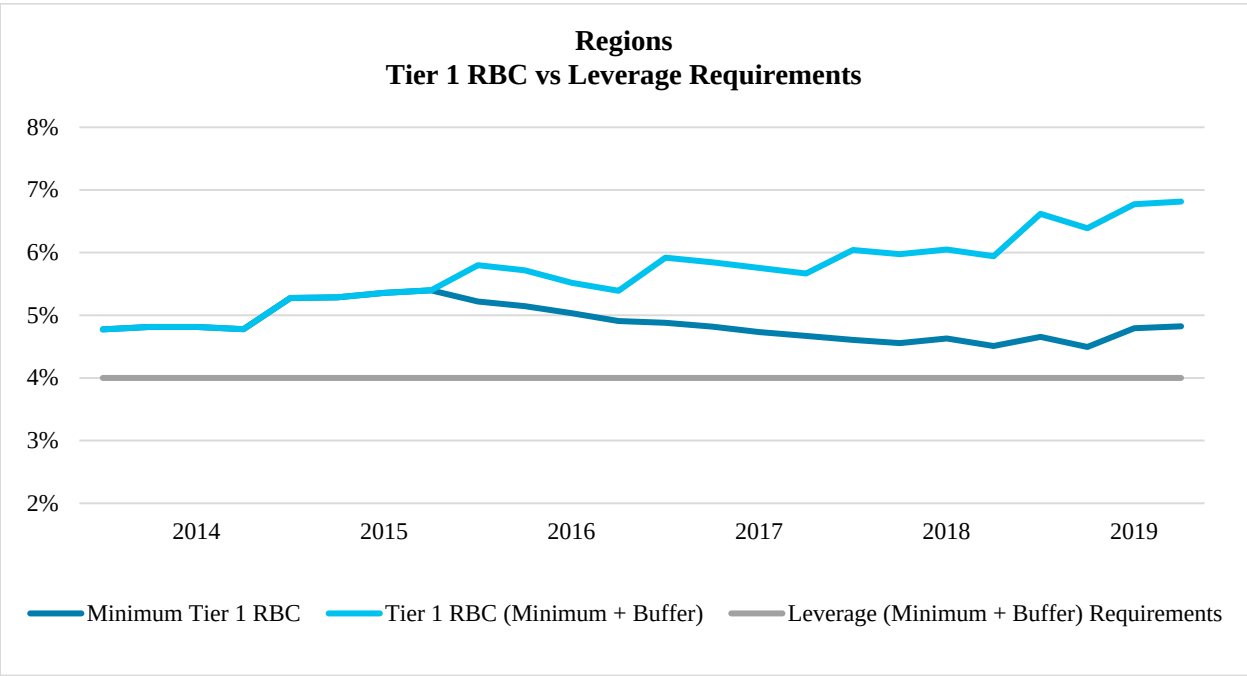
* Prior to 2018, Tier1 RBC is expressed as a % of Total assets for the leverage ratio (FR-Y9C), which is subject to the 4% PCA Leverage requirement. Post 2018, RBC is expressed as a % of Total Leverage Exposure, which is subject to the total leverage requirement of 5% under the SLR framework.

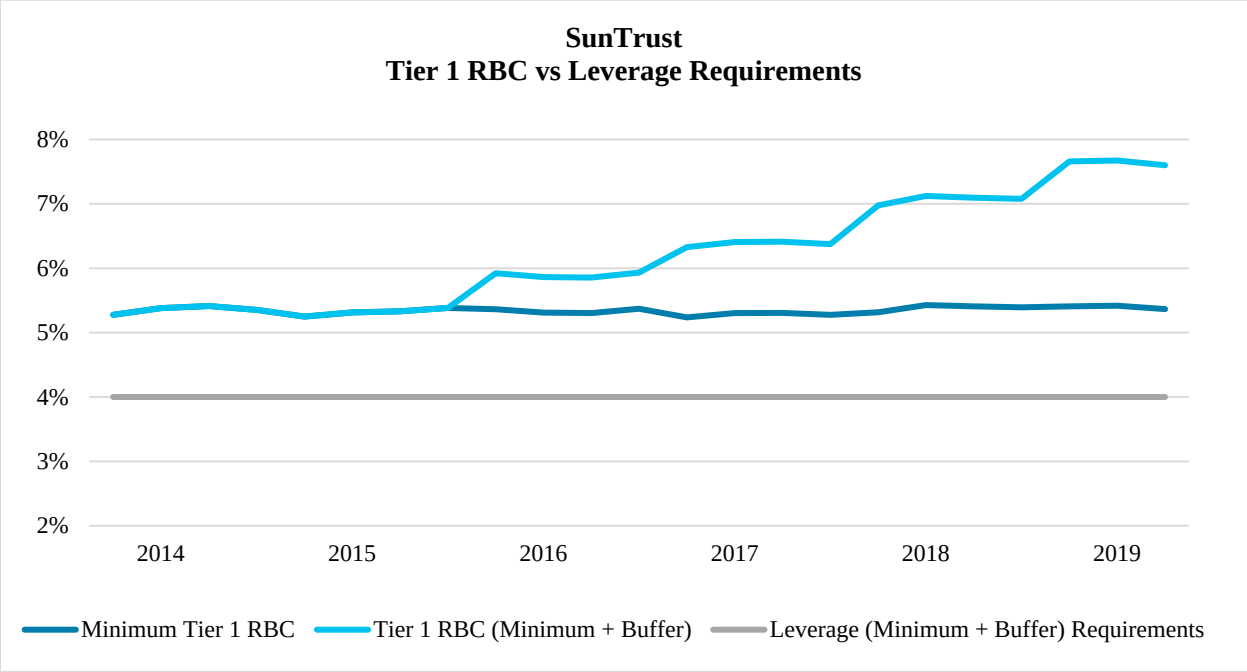


* Prior to 2018, Tier1 RBC is expressed as a % of Total assets for the leverage ratio (FR-Y9C), which is subject to the 4% PCA Leverage requirement. Post 2018, RBC is expressed as a % of Total Leverage Exposure, which is subject to the total leverage requirement of 5% under the SLR framework.



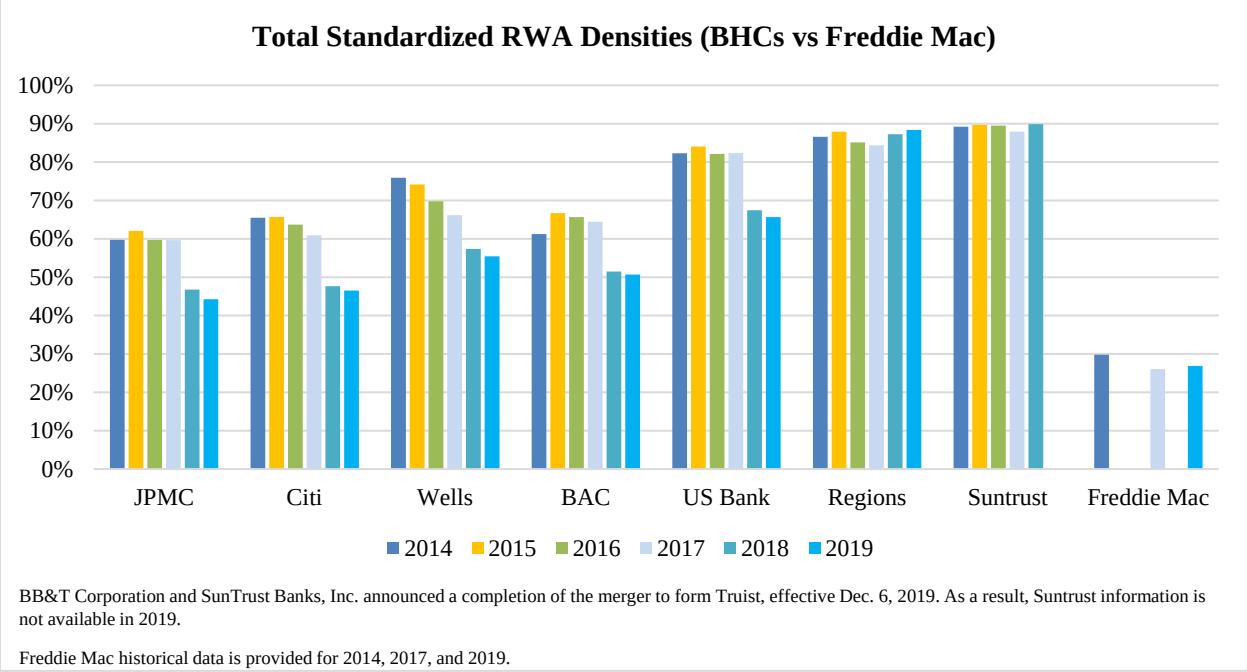
* Prior to 2018, Tier1 RBC is expressed as a % of Total assets for the leverage ratio (FR-Y9C), which is subject to the 4% PCA Leverage requirement. Post 2018, RBC is expressed as a % of Total Leverage Exposure, which is subject to the total leverage requirement of 5% under the SLR framework.




SunTrust
Tier 1 RBC vs Leverage Requirements
8%
7%
6%
5%
4%
3%
2%
2014
2015
2016
2017
2018
2019
Minimum Tier 1 RBC
Tier 1 RBC (Minimum + Buffer)
Leverage (Minimum + Buffer) Requirements

Appendix F.5. Historical Standardized RWA Densities (BHCs vs Freddie Mac)

Freddie Mac has lower RWA density than that of U.S. commercial bank G-SIBs, including those with large mortgage portfolios, as well as lower RWA density than that of selected regional banks that engage in significant retail and mortgage lending.



BB&T Corporation and SunTrust Banks, Inc. announced a completion of the merger to form Truist, effective Dec. 6, 2019. As a result, Suntrust information is not available in 2019.

Freddie Mac historical data is provided for 2014, 2017, and 2019.

G. The PCCBA

Appendix G.1. Historical DFAST Pre-Tax Net Income (losses) (BHCs vs Freddie Mac)

Freddie Mac's pre-tax losses under DFAST as a percentage of total assets have consistently declined over the past four years, compared to the banks' losses which have significantly fluctuated.