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**The FHFA's Report on Credit Risk Transfer:
Another Controversial Document Further Erodes
Confidence in the Agency**

Many Wait for the Supreme Court Ruling on Director Independence

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Introduction

The Federal Housing Finance Agency (FHFA), the regulator and conservator¹ of Freddie Mac and Fannie Mae, the two government-sponsored enterprises (GSEs), earlier in May released a report titled “Performance of Fannie Mae’s and Freddie Mac’s Single-Family Credit Risk Transfer.”²

As I have noted on many occasions, everything about the GSEs is highly politicized. Consequently, many and perhaps even most articles or speeches about them are biased, sometimes a little and sometimes a lot, in favor of the economic interest or ideological viewpoint of the author or speaker. For example, the mortgage industry always advocates for policies and actions good for its bottom line, and against anything that will raise its costs. Free-market advocates believe everything the GSEs do is ineffective or harmful, and so anything to shrink or eliminate them is a good idea. Such advocacy positions are, not surprisingly, accompanied by high-minded language about being “data-driven” or motivated solely by what is good for the country – claims I found few in Washington took seriously.

In my seven years at the heart of the housing finance system as CEO of Freddie Mac, I unfortunately found that such biased, advocacy-driven analyses dominated policy discussions in Washington – not only because of their sheer numbers but also because they are heavily promoted. It is against this background that I find the FHFA’s credit risk transfer report meaningful in terms of housing finance policy, but in two distinct ways.

First, the CRT Report is a classic Washington-style advocacy document, as described above. It starts with the predetermined conclusion that “CRT doesn’t work,” a position articulated by the director of the FHFA, Mark Calabria, from his first days in office.³ It then cherry-picks data and slants arguments

¹ The FHFA, as conservator over the two GSEs, has total legal control of each company, having all the authority of their shareholders, their board of directors and their management.

² I will henceforth refer to this document as the “CRT Report.” See <https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Overview-05172021.pdf>. In the interest of full disclosure, as Freddie Mac CEO I was a key figure in the development and implementation of single-family CRT, of which I am still a strong supporter. Also, the CRT Report only addresses single-family CRT; unmentioned is multifamily CRT, which was developed at Freddie Mac prior to my arrival.

³ I can personally attest to this, as Director Calabria expressed this view of CRT during our small period of overlap in 2019. Interestingly, this view is shared by very few people. CRT has support across the political spectrum in Congress, as both Democrats and Republicans like seeing taxpayer exposure to the GSEs reduced, which is one of the things CRT does. Only a very small group of people, mostly well-known extreme naysayers about the GSEs, hold this anti-CRT viewpoint. I have been asked many times why they hold this view. I believe it stems from CRT’s development and implementation having strengthened the business model of the GSEs, making their continuing to play a major role in housing finance more likely as policymakers contemplate reforms to accompany the GSEs’ eventually exiting conservatorship in some fashion. As such an outcome is viewed poorly by those who believe it is

to support that predetermined conclusion, ignoring or dismissing any argument to the contrary. (One knowledgeable reader of the report told me, “It seems to say not a single good thing about CRT.”) And, of course, it uses the obligatory high-minded language – in this case, claiming that it is simply a research report examining facts.

The paper, after reviewing how various CRT transactions work and some of their historical background, proceeds to go through a laundry list of nearly every criticism of CRT that has been or could be made, regardless of how minor or self-interested the source. I find the related commentary slanted in all cases to cast doubt on the program. Meanwhile, it ignores virtually all the benefits of CRT, not mentioning those widely discussed over the years by policymakers, such as reducing systemic risk as well as taxpayer exposure to the GSEs. For readers who do not know much about CRT (it is admittedly an obscure field), the report will naturally lead them to conclude that the program must be highly troubled; it will thus fulfill the purpose of an advocacy piece, which is to convince the less knowledgeable. However, for those in housing finance who are experienced enough in CRT to understand its functioning and its benefits, the report erodes confidence in the FHFA’s credibility, for its bias represents a drastic departure from the even-handedness expected of an independent regulator.⁴

But it is the second characteristic of the CRT report that is perhaps more important. This is the fourth in a string of recently released major FHFA documents that have been driven by a zealous free-market advocacy viewpoint that the GSEs should be shrunk if not eliminated altogether.⁵ This viewpoint puts these reports outside the mainstream of views held in the housing finance industry and broader policy community.⁶ As a result, I have found that these communities’ confidence in the FHFA as a proper

good public policy for the GSEs to be, ideally, eliminated altogether, they find it tactically advantageous to their advocacy efforts to claim that “CRT doesn’t work.”

⁴ Regulatory agencies, whether led by a single individual or a commission, are run by political appointees, who can therefore sometimes have strong views on various policy matters. However, in decades of dealing with financial regulatory agencies, I have found that they overwhelmingly work to maintain their credibility by presenting their homework and research in a fact-based and relatively neutral manner, with only conclusions reflecting policy choices. This is what I mean by the phrase “even-handed”: facts on both sides of an argument are admitted and presented fairly, separately from policy and political considerations or judgments. (This is roughly analogous to the traditional separation of news reporting versus editorial opinion in a newspaper.) By contrast, advocacy research slants things right up front, so it is absolutely not “even-handed.”

⁵ Two of those documents are about regulatory rules, so feedback on them was submitted by the public before the proposed rules were finalized. While one such proposed rule was obscure enough to receive few comments, the other (the Enterprise Capital Rule) was very heavily commented upon. That feedback, which overwhelmingly countered the free-market advocacy slant of the proposal, was pointedly almost totally ignored by the FHFA in terms of the substance, although there were some optics-oriented changes made.

⁶ I have reached this conclusion by reading a wide variety of industry newsletters and publications, holding many private conversations, and watching industry panels and webcasts. I note in particular that industry representatives are very reluctant to talk on the record about their unease, but will do so in private.

and impartial regulator has taken multiple hits.⁷ The CRT Report completes the picture, leaving little doubt that the FHFA now operates with a level of advocacy and lack of even-handedness that put it outside the bounds of normal regulator behavior.

In fact, key figures in the industry – not so much publicly, but certainly privately – have begun to view the FHFA itself as a source of instability in the housing finance system as it has developed a reputation for taking actions that require the industry to make abrupt and significant changes to their operations and business models, with consequent disruption for borrowers as well.⁸ That’s a bad reputation for a regulator to have.

Below, I quickly review the three earlier documents and show how they are absolutely controversial and questionable, and have justifiably reduced confidence in the objectivity (and sometimes the technical skill and forthrightness) of the FHFA. I then analyze the CRT Report, the latest such controversial document, to show the extent to which it is a strongly biased advocacy document.

So, what are the housing finance industry and so others involved in the field to do in this extraordinary situation where the regulator has, in their view, so abandoned even-handedness? I hear, directly and indirectly, that many are throwing up their hands and wondering if engagement with the FHFA to correct the situation is worth the effort. Given that the term of Director Mark Calabria, whose strong free-market advocacy viewpoint dominates the agency, lasts through 2024, there is real concern (and even fear) about how things will transpire during the remaining three years. However, a case now before the Supreme Court (*Collins v. Mnuchin*) will decide, among other items, whether the FHFA director’s independence is constitutional; that independence is rooted in language that an incumbent can be fired by the president only “for cause” (which is not defined). The expectation in the industry is that such independence will be ruled unconstitutional, and President Biden could fire Director Calabria

⁷ One example of this decline in confidence, in response to the PSPA revisions in January 2021, was a letter of April 16, 2021 from seven organizations to Director Calabria and Secretary of the Treasury Yellen requesting that all the restrictions in the PSPA be delayed, with language indicating great concern about FHFA behavior (see <https://www.nafcu.org/system/files/files/NAFCU%20Letter%20to%20Dept.%20of%20Treasury%20and%20FHFA%20on%20Main%20St%20Coalition%20PSPA%20Changes.pdf>). Another would be the proposed capital rule comment letter (an example of the many negative comments submitted) to the FHFA from the Mortgage Bankers Association, the most prominent housing finance industry association, which in particular dwells on how poorly the proposed rule treats CRT (see <https://newslink.mba.org/mba-newslinks/2020/august/mba-newslink-tuesday-sept-1-2020/mba-letter-asks-fhfa-to-develop-new-gse-capital-framework/>).

⁸ The first recent well-known example of such disruption occurred in 2020 with a 50-basis point fee to be charged on most refinancing loans, originally scheduled for implementation on September 1, 2020. Implementation was postponed to December 1, 2020 after the industry complained vociferously that more time was needed for non-disruptive implementation. For an industry insider’s balanced perspective, see “The Agency Refinance Fee: Delayed but Not Forgotten,” <https://www.stratmorgroup.com/the-agency-refinance-fee-delayed-but-not-forgotten/>.

at will, like any other executive branch official – and likely would do so quickly.⁹ The hope is that this ruling, which is scheduled to come out within weeks, will lead to the appointment of an FHFA director who would be more mainstream and reverse the recent damage done to the FHFA’s credibility by restoring its reputation as an even-handed regulator.

Three Controversial Documents

The FHFA, prior to releasing the CRT Report, has issued in less than a year three documents that have proven quite controversial, as they are generally seen as substantially biased to support a view that the GSEs should be shrunk if not eliminated. The specifics of these documents are additionally concerning, sometimes throwing into question the technical skill of the FHFA and even its forthrightness. Industry reporting has indicated, and my private conversations confirm, that each document has reduced the FHFA’s credibility for many, and perhaps even for most, in the housing finance community.

The enterprise capital rule¹⁰

In November 2020, the FHFA approved a final Enterprise Capital Rule to apply to the two GSEs.¹¹ As legally required for an official regulatory rule, FHFA had earlier put out its proposal for public comment. The reaction was exceedingly critical. While the proposed rule would raise the cost of mortgage credit, which is naturally opposed by industry interests (homebuilders, realtors, mortgage bankers, etc.), I found that the criticism in the public comments submitted went well beyond that concern. The list of the 128 comments submitted also went beyond “the usual suspects.”

There were *three major criticisms*:

1. *The total capital required was too high by far.* Prior to 2008, the regulatory required capital was much too low. From 2014 to 2017, the FHFA developed for use during conservatorship a modernized capital requirement – broadly consistent with the underlying economics of large

⁹ This expectation is based mainly upon a similar case last year related to the Consumer Financial Protection Bureau (*Seila Law v. CFPB*), in which the CFPB director’s independence from being fired without cause was eliminated.

¹⁰ I wrote two previous articles on the capital rule: “The New Proposed Capital Rule for Freddie Mac & Fannie Mae: Ten Quick Reactions,” <https://www.jchs.harvard.edu/blog/the-new-proposed-capital-rule-for-freddie-mac-fannie-mae-ten-quick-reactions>, and “FHFA’s Final GSE Capital Rule: Little Credibility and a Short Shelf Life,” <https://www.jchs.harvard.edu/blog/fhfas-final-gse-capital-rule-little-credibility-and-short-shelf-life>.

¹¹ For an informative factsheet on the final rule, see: <https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/FS-Final-Rule-on-Ent-Capital.pdf>.

bank regulatory capital systems – that called for, in aggregate, capital in the \$135 billion range.¹²

The FHFA’s 2020 proposed rule called for \$263 billion in capital, an amount which therefore seemed much too high, being about *six times* the size of the more conservative view of losses calculated under the then-latest government-supervised “severe adverse” scenario stress test.¹³

2. *The impact of the capital rule at the transaction level was often in conflict with good economics.*

This conflict indicated how little attention was paid to this aspect of what constitutes a proper capital rule. In fact, there was much criticism that the simple leverage ratio – which gives no credit for risk reduction, just for reducing nominal accounting assets regardless of risk – was dominant, making almost irrelevant the risk-based calculations in the proposed rule, which are designed to reflect proper economics.

3. *CRT was treated poorly, with relatively little capital relief given for such transactions.*¹⁴ This treatment was the first official sign that the FHFA was hostile to CRT transactions. The low level of capital relief did not comport with economic reality, and so was also highly criticized, including by elected members of Congress from both parties.

Nevertheless, the FHFA went ahead and approved the rule with only nominal changes. In fact, one change it made to address the CRT-related criticism, to give more capital relief credit than previously, was in fact vitiated by a revision of a certain non-risk-based minimum so that, net, the percentage of credit risk offset by CRT actually went *down*, not up!¹⁵ The total capital required by the final rule also went up to \$283 billion, not down – in direct opposition to the widespread criticism.

¹² Given what was learned subsequent to the creation of the modernized capital requirement, I estimated in the second of my articles (referenced above) the “right” number for capital was in the \$175 billion range.

¹³ The stress test (see https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2019_DFAST_Severely-Adverse-Scenario.pdf) loss was calculated two ways: at \$18.0 billion assuming no loss of certain tax benefits, and \$43.3 billion with such a loss. I have used the more conservative \$43.3 billion in the above calculation. Using the more liberal calculation, the capital requirement was *fourteen* times the severe adverse stress loss.

¹⁴ Only about 16 percent of the credit exposure was considered offset by CRT (a combination of both the single-family and multifamily businesses). Under the capital rule used during the conservatorship until that point, the percentage was roughly double that level. The 16-percent figure was later revised upward to just over 20 percent.

¹⁵ The revision in question was to the “risk weight floor” used to calculate the credit risk capital on mortgage exposures, which was increased from 15 to 20 percent, more than offsetting a slight (i.e., only 8 percent) increase in the CRT relief given. I know industry figures who believe that the FHFA’s claim to have increased CRT capital relief in response to the critics (including Republican members of Congress), even though the increase was then more than offset so that the actual percentage of capital relief went down, was simply and inappropriately too much about political optics and not actual substance – and so came across as misleading.

As a result, the credibility of the FHFA as an even-handed regulator was eroded, and the ideological bias towards forcing a shrinkage of the GSEs, which is what an inordinately high capital requirement will do, was seen as being too much in the driver's seat.

The PSPA revision¹⁶

When the GSEs were privatized decades ago, their business model nevertheless required that the government support the creditworthiness of the two companies. This support was originally given via the "implied guarantee," whereby the government, without actually issuing a formal guarantee, sent signals to the marketplace that the GSEs would not be allowed to default.¹⁷ Under the stress of 2008's financial markets, and especially the losses then building in all mortgage assets, the implied guarantee was not enough to maintain the market's confidence, and it was replaced by a stronger, written legal agreement called the Preferred Stock Purchase Agreement (PSPA), which was established coincident with the two companies' being put into conservatorship.¹⁸

In September 2019, the PSPA was amended to allow the GSEs to retain earnings to build capital. That was a very positive change, but for some never-explained reason was limited to \$45 billion total (\$25 billion for Fannie Mae, \$20 billion for Freddie Mac), and late in 2020 Fannie Mae was approaching its limit. It was therefore another positive change that, in January 2021, in the very last days of the Trump administration, there was another revision to the PSPA to allow capital to be further retained.

Unfortunately, that revision also included a laundry-list of non-capital related limitations on the business activities of the GSEs. While some of the limitations focused on types of mortgages with which it was legitimately debatable whether the GSEs should be involved at all (e.g., second homes, investment properties), others were wholly unexpected and had no obvious legitimate rationale. For example, there was a limitation on how much lenders could sell mortgages directly to the GSEs (known as "using the cash window") rather than do securities swaps with them (where the primary market

¹⁶ I wrote a previous article on the PSPA revision: "Revisions to the GSE Treasury Support Agreement: Some Substance, Some Political Optics, and Treasury Gains Power," <https://www.jchs.harvard.edu/blog/revisions-gse-treasury-support-agreement-some-substance-some-political-optics-and-treasury>.

¹⁷ And in fact, the implied government guarantee proved to be true, as the two companies were rescued in 2008.

¹⁸ The PSPA is still not a full formal guarantee. Instead, it is a binding legal contract by which the Treasury agrees to invest up to certain large amounts to prevent the net worth of each GSE from going below zero. While it is still not a formal guarantee and does have a cap on how much support can be given, it is certainly stronger than the implied guarantee of pre-2008 years. It has absolutely been strong enough to regain, and maintain ever since, market confidence in the GSEs.

lender deals directly with the mortgage-backed securities [MBS] markets).¹⁹ This limitation was specified in such a way that it impacted, with little notice to allow for planning, many mid-sized lenders which then had to scramble to change their business models. (This second scramble by primary-market lenders – the first having centered around a 50-basis point fee on refinance loans established in 2020 – created the notion among some in the housing community that the FHFA was itself a cause of market instability.)

As a second example, the limitations also covered “high-risk” mortgages, using a simple formula to define them – again with no notice. And it certainly seemed odd to include such a limit in a capital support agreement document; after all, the risk-based capital formulae of the just-approved Enterprise Capital Rule were already supposed to appropriately discourage such mortgages. There were additional restrictions as well.²⁰

The common thread in the limits was to shrink the activities of the GSEs, with seemingly little thought given of the collateral damage done to the industry or borrowers during both a transition period and in the long term. So, ideology seemed to be even more in the driver’s seat than had earlier been concluded.

The living will rule²¹

Earlier this month, the FHFA finalized a “living will” rule – formally known as “resolution planning.” The agency had earlier, in December 2020, released the proposed rule for public comment. This type of topic is very obscure and did not attract much attention at the time, with only fourteen comments received from the public. It has started to get some attention very recently, after it was finalized, as its implications – which are highly problematic – became better known.

¹⁹ I am not aware of any official public reason given by the FHFA for this limitation. I know several people who attribute it to the FHFA’s general desire for the GSEs not to do anything that the private sector could do instead.

²⁰ At a technical level, the method chosen to measure actual results against the limits (i.e., a 52-week rolling average) revealed inadequate knowledge or homework on how to do so in a practically implementable manner. Such a weekly calculation allows no flexibility in the face of short-term fluctuations; in contrast, as an example, a calendar-year average would allow some ability to absorb fluctuations while still hitting an annual target. So, this method became another minor cause célèbre among primary-market lenders, as it required that they and the GSEs maintain cushions so as to not exceed the weekly-calculated limits – a requirement which exacerbates the tightness of the limits.

²¹ I previously wrote an article on the living will rule: see “The FHFA’s Proposed GSE ‘Living Will’ Rule: Fatally Flawed and Unusually Vague,” <https://www.jchs.harvard.edu/research-areas/working-papers/fhfas-proposed-gse-living-will-rule-fatally-flawed-and-unusually>.

The rule calls into question how forthright the FHFA is being about how the rule would actually work in practice, not just conceptually. Cutting through all the language and complexity, at its core the rule says three key things:

1. The FHFA as regulator can, solely on its own authority, put the GSEs into receivership, especially if they are inadequately capitalized according to the recently approved Enterprise Capital Rule, which they will be for many years because of the specifics of how the two companies were rescued by the government.
2. In receivership, the assets and activities of the GSEs are to be divided up into two parts. First, there are so-called non-core activities (which the GSEs are initially required to identify as part of the resolution planning process), which will be liquidated (akin to how a Chapter VII bankruptcy works). The rest of the assets and activities will be put into a new company that will inherit the charter of its predecessor to then get back into business to support the mortgage market (akin to how a company goes through a Chapter XI bankruptcy reorganization to emerge to operate again).
3. While this superficially seem reasonable so far, there is a “gotcha” clause: each new company is prohibited from receiving “the provision or continuation of extraordinary support by the United States [Government].”²² According to the FHFA, this prohibition includes the existing PSPAs, which then cannot be replaced in any manner. But the PSPAs or something roughly equivalent are absolutely necessary to the business model of the GSEs, and the reorganized companies cannot continue in business without such government support – something which the FHFA has not been forthright about.²³ So, each “new GSE” will be dead-on-arrival, unable to actually do business, and thus apparently will – gotcha! – end up being liquidated, too.

²² FHFA, “Resolution Planning: Final Rule,” 12 CFR Part 1242, <https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/2021-09287.pdf>.

²³ The PSPAs are not like the “extraordinary support” a bank might temporarily get in a government rescue; rather, they are akin to deposit insurance – they are needed routinely for ongoing operations. The history of GSE government support, in which the government itself obfuscated things by employing an implied guarantee, is what allows there to be confusion on this point. But there is no confusion on the part of the industry or policymakers in housing finance that government support is required for the GSE business model to operate – which is why virtually every legislative proposal for GSE reform includes a full-faith-and-credit guarantee to the mortgage-backed securities issued by the two companies (as received already by GNMA), with a fee to be paid for the support.

Net, the living will rule is a document which, in a somewhat disguised manner, requires full liquidation of the companies upon their being put into receivership. This requirement fits exactly into the long-time “shrink or eliminate the GSE” objective of the free-market zealots.²⁴

So, for a third time, ideological zealotry seems to be driving the FHFA’s actions, adding to its reputation in the housing finance community for being outside the norm for independent regulators.

The CRT Report: A Fourth Controversial Document²⁵

The purpose of this section is not to do a soup-to-nuts analysis of the CRT Report from the FHFA. It is instead to demonstrate that the report is a pure Washington-style advocacy document, meaning it starts with its conclusion (that CRT doesn’t work) and then cherry-picks data and slants arguments to highlight negatives about CRT (spinning each one so that it seems to the typical reader to be a major design flaw), even as it conspicuously ignores any benefits of the program, and all the while maintaining a high-minded tone that it is just a research report. I will do this by pointing out four major benefits that are mentioned almost not at all, showing how several of the highlighted negatives are either incorrect or of relatively immaterial consequence, and adding in a few other points to solidify the argument.

Here are four important benefits of CRT either not mentioned or just slightly referenced in passing:

1. *Systemic risk reduction.* The Achilles heel in the design of the GSEs is that they concentrate trillions of dollars of credit risk on a single asset class (i.e., single-family mortgages) into just two companies. Specifically, today, this amounts to about \$5.5 trillion of such risk between them (half of the outstanding total of single-family mortgages in the country). This concentrated risk is a significant design flaw because it poses a systemic risk to the American financial system, and it was a prime cause of the loss of confidence in the GSEs back in 2008. To date, the only known way to practically and effectively reduce this undue concentration of credit risk (absent some

²⁴ The more conspiracy-minded believe that such liquidation is the plan: the living wills for each company will be developed and blessed while FHFA Director Calabria is still in office during his five-year term, and he can then order the GSEs put into receivership for inadequate capitalization, which translates into full liquidation by the “gotcha” working of the resolution planning rule.

²⁵ I wrote a three-part series entitled “Demystifying Credit Risk Transfer” to be a primer on CRT. See Part I: “What Problems Are We Trying to Solve?” <https://www.jchs.harvard.edu/research-areas/working-papers/demystifying-gse-credit-risk-transfer-part-i—what-problems-are-we>; Part II: “How, and How Well, Does It Work?” <https://www.jchs.harvard.edu/research-areas/working-papers/demystifying-gse-credit-risk-transfer-part-ii-how-and-how-well-does-it>; and Part III: “Special Interests and Politicization,” <https://www.jchs.harvard.edu/research-areas/working-papers/demystifying-gse-credit-risk-transfer-part-iii—special-interests-and>, especially pages 31-37, which directly relate to the topic of this article and provide further background for it.

unspecified major revamping of how housing finance is done in America that does away with the GSEs in their current form) is via CRT, which puts the credit risk into the hands of more than a hundred institutional investors around the globe to achieve systemic risk diversification.²⁶ This strategic improvement in the stability of the country's financial system is, consistent with the advocacy nature of the CRT Report, ignored by the article.

2. *Taxpayer risk reduction.* CRT is the only known way to reduce the exposure of the taxpayer to the risks of the GSEs while they are in conservatorship – and possibly afterward – at a reasonable cost while they still achieve their congressionally-directed mission. CRT reduces taxpayer exposure not just to very large losses exceeding the current capital of the GSEs, which would then necessitate a draw under the PSPAs. It also reduces exposure to losses large enough to exceed the operating earnings of the GSEs, which would in turn require them to dip into their current capital cushions; as those capital cushions are effectively almost wholly owned by the taxpayer, any reduction in them is an economic loss to the taxpayer as well. This benefit is also unmentioned in the CRT Report. I note that policymakers in Congress in both the Democratic and Republican parties have long regarded such taxpayer exposure reduction as a major value of a CRT program.
3. *Capital reduction.* The direct benefit from CRT is that it reduces the needed capital level for the GSEs – i.e., the resources needed to absorb losses beyond a normal and recurring level.²⁷ The CRT Report's analysis, which compares amounts paid out and monies received on CRT without counting the reduced need for capital (and thus a reduced cost of capital), is like one hand trying to clap – it is meaningless.²⁸ It is also absolutely misleading, even if not so intended; for the calculation to be meaningful, it has to include the economic impact of the capital reduction associated with CRT. (If the economic savings in the cost of capital are included, the CRT

²⁶ The focus of this credit risk transfer is, completely appropriately, not on routine risks easily absorbed by the companies in the ordinary course of business, but on deeper losses that matter when it comes to market confidence and stability concerns.

²⁷ I am referring here to the reduction in true economic capital. Regulatory capital requirements try to emulate true economic capital, but can deviate from it for various reasons. In the case of the FHFA's Enterprise Capital Rule, it so deviates by giving inadequate capital relief from CRT, reflecting the agency's bias.

²⁸ See CRT Report, 21-23. Such a reduced "cost of capital" is the major economic driver of CRT transactions as they aim at non-routine losses that could impact market confidence. I note many people, drawing upon their personal finances, will compare this CRT calculation to homeowner's insurance, i.e. that they would not cancel it if, after a period of few losses, the cumulative cost of the insurance was greater than the benefits – which seems to be the intended implication of the report. For a regulated financial institution, which needs to keep capital against such possible losses, one can make a calculation: is it better to purchase the insurance (i.e. in this case enter into CRT contracts) or keep the capital needed to cover the same risk without insurance? This type of calculation was made for every single CRT transaction done by Freddie Mac.

program would then show positive earnings, not the negative cited in the report.) In fact, more generally, the report seems to confuse losses that are normal and easily absorbed by the companies from current earnings (known as “expected losses” in finance, which are intended to be covered by loan loss provisions) with those losses that are larger, putting stress on market confidence in the companies (“unexpected losses,” which are intended to be absorbed by capital). CRT is absolutely designed to primarily address the latter – something the report mentions in passing only once, on the second-to-last page.²⁹

4. *Market discipline.* The credit quality of the mortgages guaranteed by the GSEs has long been a politically charged topic.³⁰ CRT has allowed unbiased market participants – who put up real money to invest in CRT instruments – to express a more credible view of that credit quality, and to do so every day of the week via secondary trading. And they do so on specific tranches of specific pools of mortgages for much greater granularity.³¹ This practice makes it less likely that the GSEs can allow the credit quality of their books of business to get too loose (which happened prior to 2008, to disastrous results) or too tight.

Until the FHFA began to push against CRT with the recently completed capital rule, CRT by both GSEs – actively encouraged by the previous directors of the FHFA, one of whom was a liberal and one a conservative – had reduced by very significant percentages all three of systemic risk, taxpayer exposure, and capital need. By ignoring this history, the report betrays its lack of even-handedness and its true function as advocacy.

With the laundry-list of criticisms and undermining comments that constitute the analytical core of the FHFA’s CRT Report, it unfortunately seems to me that the FHFA is just throwing every piece of mud to see what sticks and gets CRT dirty. To demonstrate this reality, I have chosen three of the highlighted criticisms to show the extent to which the FHFA has abandoned fundamental even-handedness in its advocacy zeal, and is unduly engaged in spinning.

1. *Disruption during periods of market stress.* The CRT Report states that “concerns have been raised that CRT markets may be *easily* disrupted during periods of market stress, requiring the

²⁹ This ignoring of the benefit of CRT’s absorbing such unexpected losses if they were to occur, and thus reducing the need for capital, is also wholly inconsistent with the FHFA’s own capital rule, which highlights the need for capital to absorb just such highly unlikely losses (up to a level of 5 percent or so of assets) rather than routine ones.

³⁰ Liberal think tanks analyze the credit risk numbers and always conclude that credit quality is clearly too tight, while conservative ones do the same and always conclude it is clearly too loose. Such is the nature of advocacy.

³¹ To convert market prices on individual tranches back to a meaningful picture of a pool of mortgage credit requires considerable technical financial skill.

Enterprises to retain credit risk they had planned to transfer” (24, my emphasis). This statement is accurate in a sense, for it is true that such concerns have been raised over time, but the report’s tone implies that the concerns point to some type of fatal flaw in CRT. Notice, too, how there is no attribution of who has the concerns and what their motivation might be. The question for a regulator, rather than an advocate, is whether such concerns are legitimate and valid and problematic, not just whether they have been made in such a politicized industry. The reality is as follows:

- a. *CRT has shown how much better than expected is its resiliency.* Since its introduction in 2013, CRT had only a few days of market interruption (e.g., the unexpected vote for Brexit) until the pandemic hit, which caused one of the greatest market stresses in modern history (even highly-liquid agency MBS markets were disrupted, which is indeed troublesome) that resulted in the market for new transactions being practically unacceptable in terms of cost (i.e., “closed”), but only for about four to six weeks. (The FHFA allowed the GSEs to re-enter the markets only after about a further month, though.) This track record totally refutes the notion that CRT markets can be “easily” disrupted: it took an extremely severe stress to disrupt them, and even then the period of disruption was quite short.³² In that sense the pandemic actually showed that CRT securities, despite being rather specialized, have strong resiliency and are *not* easily disrupted, contrary to the CRT Report’s spin.³³
- b. *The damage done by the pandemic-related disruption was negligible.* The CRT markets were disrupted for a short time: how bad a problem did that cause? The report’s answer is vague: such a disruption may “[require] the Enterprises to retain credit risk they had planned to transfer.” The report does not address, however, whether that retention is a problem, and if so, how large a problem it is. The answer, in fact, is that it creates a very small problem, really negligible. The GSEs, by their nature, are well able to absorb such a

³² There were earlier concerns expressed in conversations with the FHFA over the years that any market disruption would close the CRT markets for possibly a year or even two. By closing in such a severe disruption for under two months, the markets out-performed these dire expectations.

³³ In the paragraph about market disruption, the CRT Report notes that Fannie Mae “had not resumed CRT issuance as of end-February 2021” (4). The implication that Fannie Mae did not re-enter the market because of the disruption is spin: the GSE stopped CRT issuance due to the inadequate capital relief given by the proposed new Enterprise Capital Rule released in May of 2020, i.e. at the same time (see <https://www.bloomberg.com/news/articles/2020-10-26/a-50-billion-housing-bond-market-is-stuck-in-regulatory-limbo>). I note that, on page 24, a somewhat fuller description does mention, in an oblique manner, that the new capital rule proposal had been issued, although it makes no direct connection to Fannie Mae’s cessation.

temporary increase in their level of mortgage credit exposure for the few months of the disruption; they can then issue the needed CRT securities after the markets reopen. (In fact, the disruption would have to be extremely long for the GSEs not to be readily able to absorb the increased credit risk.) In the case of the recent disruption, there was no discernible impact on the markets or the financial performance of the GSEs. And, of course, all existing CRT transactions stayed in place and performed throughout the stress period – something also not mentioned in the report.

2. *CRTs remain untested by a serious loss event.* This is a true statement made by the CRT Report, reflecting benign mortgage credit markets since about 2011-12, when house prices bottomed out from the financial crisis. However, absent wishing for a major economic calamity to “prove” that CRT works, it is worth noting that CRT securities are mostly patterned after “insurance-linked notes” (also known as catastrophe bonds, or “cat bonds” for short). Cat bonds have performed perfectly properly during periods of stress caused by, for example, hurricanes. But in a strange manner, the CRT report then veers off into recounting a minor episode affecting a very limited number of investors in the earliest CRT transactions, which used a simpler structure as the product was just being newly introduced into the market. Specifically, the interaction of the contract language in those earliest deals and the institution of large-scale forbearance by the GSEs in the pandemic raised questions about how forbearance was to be treated.³⁴ The small number of investors not surprisingly wanted treatment favorable to themselves, and as a negotiating tool a subset of those investors (and it may have only been one) threatened that they would not invest in future CRT transactions if they did not get that favorable treatment. As conservator over both companies, the FHFA decided to not grant the investors’ request, directing the two GSEs to implement its decision. The recounting of this event in the report seems to imply that some sort of stress test was failed, i.e. that CRT investors are fickle and will unduly leave the market on a permanent basis after a stress event. That’s just spin. Meanwhile, in reality, the impact of the dispute on the markets was nil, as CRT issuance volumes since the disruption period ended have been very high, and the number of institutional investors in CRT is now more than a hundred – so it would be immaterial if one, or even a few more, dropped out.

³⁴ Similar issues developed in other aspects of the mortgage markets, including the large and liquid agency MBS market itself.

3. *The counterparty risk of insurance/reinsurance CRTs.* After noting that securities-form CRT transactions have full collateralization, the CRT Report also observes that insurance/reinsurance CRTs (which account for about one-quarter of all CRT transaction volumes) do not, which is absolutely true. It then shows a chart with the ratings by AM Best of the insurance companies providing this coverage and what percentage of the maximum exposure is collateralized by cash. In the introductory summary of its findings, the report says that “*only* about 26 percent” of the maximum exposure is collateralized, on average (2, my emphasis). The spin of the CRT Report is that the risk of non-performance by these counterparties is therefore unknown and may be high. In fact, the ratings of the insurance companies and their level of cash collateral (the latter calculated to cover at least the loss from a severe stress scenario) together provide very strong assurance that any losses covered by such CRT transactions will be paid to the GSEs as required by the contracts, even if there are large losses.³⁵ (This commentary in the report is wholly inconsistent with how the FHFA treats mortgage insurance; for more on this topic, see immediately below.)

There are many other items listed in the CRT Report to throw doubt on CRT by way of saying “more research is required.” In all cases, the claims are either wrong, minimal in impact, or easily addressed by fine-tuning the program based upon what was learned in the pandemic.³⁶

It also must be mentioned how the FHFA in the last two years has been totally inconsistent in its treatment of CRT versus mortgage insurance (MI). When CRT was developed in 2013, the FHFA came to understand over the next few years that traditional MI is just another form of CRT, i.e. a contract, with certain structural features, that calls for credit losses to be reimbursed to the GSEs (who pay out against

³⁵ This issue was understood up front before the first such insurance/reinsurance transaction was completed, and the collateral levels were set to ensure a very low risk of the GSEs’ not receiving payment for the losses covered by the contracts.

³⁶ One such claim shows how non-credible the CRT Report can be. On page 29, it says “...the syndication process by which securities issuance CRTs are priced suggest that prices may not be equilibrating supply and demand.” In plain English, this means that, as the usual underwriting process results in more buy orders than are eventually filled, that the market price of the CRT that results is not accurate. (In this case, that means the resulting price of a CRT security upon its initial issuance is somehow biased too low, and the calculated cost of CRT thus too high versus the true economic reality.) The conclusion is that CRT pricing therefore cannot be relied upon to learn from the marketplace how GSE credit risk is viewed. In fact, for a typical CRT securities tranche outstanding for maybe four years, there is one day of underwriting-based price discovery and then about one thousand days of secondary trading – with one buy for every sell – so that secondary trading gives the pricing feedback without any such possible distortion. The fact that the CRT Report wholly ignores such secondary trading, which dominates market feedback, is just one more piece of evidence showing how thoroughly the report engages in advocacy rather than even-handed examination.

such losses to the MBS investors that they have guaranteed against the loss). As a result, the FHFA's public reporting on CRT was expanded to include MI; after all, the functions were economically equivalent and so thoroughness called for public reporting by the agency to include MI as well. However, under Director Calabria, this policy was reversed: MI was no longer exposed to the reporting or attention given to CRT, and then MI was treated unusually favorably. This reversal is shown by three examples. First, in the Enterprise Capital Rule, MI was treated totally differently than other forms of CRT, such treatment being quite favorable in contrast to the poor treatment of CRT. Second, in the CRT Report, when concerns are expressed about counterparty risk, there is shockingly no mention that MI firms have, on average, worse credit ratings than insurers/reinsurers but nevertheless are required to maintain *zero* collateral (unlike the average 26 percent for CRT), leaving there to be very material counterparty risk. Third, when the CRT Report indicates that CRT has not been tested by a severe credit loss event, it neglects to mention that MI was so tested back in 2008 – and failed miserably.³⁷ This extreme inconsistency in treatment – hostile to CRT, unduly lax on MI, even though both perform the same economic function of credit risk transfer – is just one more example of the FHFA's recent lack of even-handedness and of its domination by ideological zealotry.³⁸

Conclusion

The FHFA's reputation has been dramatically shaped by the release in less than a year of four controversial and questionable reports:

1. The Enterprise Capital Rule – broadly regarded as being too penalizing, as well as poorly constructed, which should cause the GSEs to perform their congressionally-given mission only at a higher mortgage interest rate for borrowers.
2. The revised PSPA – with its list of business restrictions on the GSEs, including restrictions on activities with no history of being controversial, indicating how much the restrictions appear to be motivated simply by a desire to shrink GSE activities.

³⁷ The 2008 financial crisis caused all seven firms then providing MI to fundamentally collapse. Three went under, three were indirectly rescued behind the scenes by the US government in order to maintain a high-LTV mortgage lending market during the downturn, and the last one, a subsidiary of AIG, was also rescued by the government through its broader AIG rescue.

³⁸ MIs have lobbied for many years to have a reputation among GSE specialists at conservative think tanks as “private capital” and therefore are treated, in my view, with kid gloves. In reality, they are subsidized private capital, with the subsidies (e.g., the lack of a requirement to post significant cash collateral) just well hidden through the GSEs.

3. The Living Will Rule – with its hidden “gotcha” requirement for full liquidation of the companies should they go into receivership.
4. The CRT Report – a classic Washington-style advocacy document, trying to maximize any possible criticism of CRT while totally ignoring or being dismissive of any benefits.

The thread running through all these reports is the ideological position that the GSEs should be forced to shrink if not be wholly eliminated. The extent to which this ideological position comes through – “zealous” is the appropriate word for it – has made it clear to the broad mortgage industry and housing finance community that the FHFA’s lack of even-handedness and forthrightness is controversially placing it well outside the norm for an independent financial regulator.

In the specific case of single-family CRT, I believe the mainstream view in the housing finance community, quite in contrast to the impression clearly intended by the CRT Report’s authors, is that the GSEs, the housing finance system, and the larger financial system of America are a lot better off for CRT’s having been developed and implemented. CRT may not be perfect – like any area of financial activity, it requires constant refining and updating as events occur – but it is far better than what existed before: a massively unhealthy concentration of credit risk in the two GSEs, no real source of market discipline to counter political pressures to be overly lax on credit risk, and too much taxpayer exposure to the risks of the GSEs, among other major problems.

The CRT Report, because it is written as an advocacy paper to undermine CRT, is therefore widely off the mark, and reveals how far the FHFA has traveled outside the mainstream of regulatory even-handedness. It’s a real shame.

So, today, the focus in the industry is not so much to engage with the FHFA to try to get policies back into the mainstream – this approach has simply failed. Instead, it is to wait for the Supreme Court to make its ruling in *Collins v. Mnuchin*, and likely then look for President Biden to replace Mark Calabria as FHFA director with someone who hopefully will repair the agency’s reputation for the level of even-handedness and forthrightness expected of any financial regulator.