FHFA Public Listening Session – Credit Risk Transfers
9/10/2020

Moderator: Welcome and thank you for joining today's conference, 2020 Proposed Capital Rule, Public Listening Session, Credit Risk Transfers. Before we begin, please ensure you have opened the chat panel by using the associated icon located at the bottom of your screen. If you require technical assistance, please send a chat to the event producer. To minimize background noises on your call, please ensure that your audio device is muted. As a reminder, this conference is being recorded. With that, I'll turn the call over to Naa Awaa Tagoe. Please go ahead.

Naa Awaa: Thank you. Good morning. This is Naa Awaa Tagoe, Principal Associate Director at FHFA. I'd like to welcome all of our attendees and speakers to FHFA's Proposed Enterprise Capital Rule, 2020 Listening Session on Credit Risk Transfer. We are delighted to have you join us for this session. As you know, CRT is an important topic for FHFA, for the enterprises and for the broader housing finance and capital markets. And we welcome your thoughts on this important topic.

And I really want to extend a special thank you to each speaker in today's session. You know, we appreciate the time you took to write a comment letter and also to come here today to elaborate on your comments and that will really inform FHFA's deliberations on the Rule.

Before we introduce the first speaker, I'm going to turn it over to my colleague, James Jordan, in the Office of General Counsel to provide some guidelines for this discussion. James.

James Jordan: Okay. So just quickly, the purpose of this meeting is to give you an opportunity to elaborate on the credit risk transfer comments included in the public comment letters you submitted to FHFA on the Enterprise Capital Rule Re-Proposal. You may also respond to FHFA's questions, seeking clarifications on your comment letters, but FHFA primarily will be in listening mode here.

So FHFA will prepare a memorandum containing a summary of the meeting discussions and your names and organizations represented as applicable. We also will be transcribing the meeting discussions and we will timely file the summary memorandum in our transcription, along with any documents and materials you give us as part of the public rule-making docket.

FHFA will not discuss the status, timing, or outcome of the Rulemaking. Anything said in this meeting should not be construed as binding on or a final decision by the FHFA Director or FHFA staff. Any questions we may

have are focused on understanding your views, and do not indicate a position of FHFA staff or the agency. Any gestures such as head nodding or shaking, facial expressions or verbal expressions such as yes or okay, made by the FHFA staff, should not be construed as agreement or disagreement to points you have presented and are simply indications that we have heard your points.

So with those disclaimers, I'll now turn it over to our first commenter speaker, who's David Gansberg, Arch Mortgage Insurance Company.

David Gansberg: Good morning. Am I coming through?

Naa Awaa: We can hear you.

David Gansberg: Great. Thank you. Well, good morning and thank you for the opportunity to present on behalf of Arch Capital Group. My name is David Gansberg and I am the Chief Executive Officer of Arch's Global Mortgage Group. In this role I'm responsible for our mortgage guarantee and credit risk transfer operations in the US and throughout the rest of the world. And it is in this capacity that I offer my comments today.

Arch's Global Mortgage Group provides mortgage insurance and reinsurance on a worldwide basis and has made a long-term strategic commitment to the US mortgage market, investing in managing and distributing credit risk in a variety of single family and multifamily executions.

Arch Mortgage Insurance is a leading provider of primary mortgage insurance in the U.S., and we also led the development of re-insurance executions for GSC CRT transactions under Freddie Mac's ACIS Program in 2013. And we continue to be a leading participant and innovator in the CRT market on both front end and backend transactions.

Since entering the US mortgage insurance market, Arch has recognized that substantial private capital is required to support a housing finance system that helps borrowers achieve sustainable home ownership while de-risking taxpayers and contributing to the liquidity and stability of the overall market.

Under the guidance of FHFA while in conservatorship, the GSEs business models have evolved from accumulating and holding credit risk on their balance sheets, to a model of accumulating and distributing credit risks

through CRT. This evolution has significantly enhanced both the diversity and amount of private capital supporting housing in the US.

The CRT program has been viewed, almost universally, as a huge success since the inaugural transactions in 2013. And since that time, a wealth of infrastructure and market expertise has been developed by private markets to analyze and price mortgage credit risk much to the benefit of sound risk management and market stability.

FHFA's most recent progress report on CRT as of fourth quarter 2019, indicates that a portion of credit risk has been transferred on over $3.5 trillion of unpaid principal balance through CRT transactions since 2013.

In Arch's view, this evolution is an essential success of the conservatorships, as well as the enterprises emergence there from and remains a critical ingredient to any administrative reform agenda aimed at ensuring the ongoing stability of the US housing finance system.

Turning now to FHFA's re-proposal of the enterprise Capital Rule, Arch views this rule as a significant and important development in the regulation of the US mortgage market and foundational to resolving the conservatorships of Fannie Mae and Freddie Mac, and to the health of the housing finance market for years to come.

It is clear to me that the staff and leadership of FHFA gave thoughtful consideration to the overall capital framework, which is reflected in the important and significant improvements that have been made to the 2018 version, that have increased both the quality and quantity of capital, and address the procyclical elements of the 2018 proposal.

Nevertheless, the new proposal falls short in achieving FHFA's objective of preserving the risk sensitive framework of the 2018 rule. The levels of risk insensitive capital required, the inability to reduce such amounts through CRT and the resulting needed increase in GSEs to cover the greater levels of equity capital, will render the GSEs uncompetitive during periods of moderate and benign credit condition.

Our analysis suggests that the GSEs footprint will dramatically shrink in good economic times as low risk loans are written by private markets and a portion of higher risk loans will shift to FHA. As a result, the GSEs will be incented to increase the riskiness of their loan portfolios at potentially inadequate prices in order to utilize idle capital.

While private capital may welcome some shift in mortgage volume to private label executions, it is likely limited by other public policies and will take considerable time to compete efficiently. The business model of the enterprises implied by the proposal in the meantime, raises two key questions.

First, whether private capital investors will be willing to deploy capital into this version of the GSA. And second, whether the GSEs will be able to continue providing stability during periods of stress and in liquid private market.

If the 2020 rule is enacted as drafted, in Arch's opinion, the answer to both questions is no. To be clear, Arch understands that one of FHFA's objections is to level the playing field with other market participants. However, capital frameworks must be tailored to the unique business models and risk profiles of the subject company.

And in our view, must be achieved in coordination with other financial regulators to ensure that private market capacity will exist to meet this evolving market dynamic.

Fortunately, Arch believes that FHFA can achieve a capital requirement that maintains the safety and soundness of the GSEs and encourages private investment in US mortgage credit, with only a few minor but important adjustments. Arch offers the following observations and recommendations.

First, the cumulative reductions of credit applied to CRT are too punitive and will disincentivize the GSEs from engaging in CRT, as we have recently seen with Fannie Mae. Arch recommends that credit for CRT be enhanced and specifically that the 10% risk weight floor applicable to the senior most tranche be eliminated.

Secondly, the proportion of risk insensitive buffer capital is too high and should be reduced and adjusted to make the overall capital requirements, more risk sensitive.

And third, the leverage ratio is overly conservative and should be reduced.

While all of these changes are necessary to balance the important objectives, I want to focus the remainder of my comments on one specific Arch recommendation that addresses our contention that the cumulative reductions of credit applied to CRT are too punitive.

That is, the elimination of the 10% risk weight floor applicable to the senior most CRT tranche. Credit for CRT, under the 2020, rule has been reduced by more than half compared to the 2018 rule.

This is largely attributable to the application of the 10% tranche floor and three effectiveness adjustments. While the magnitude of the three effectiveness adjustments are judgmentally determined, the concept for each is based on sound economic rationale and collectively they adequately address the difference in the loss absorbing capacity of CRT capital compared to equity capital.

We do not believe the same can be said for the 10% risk weighting applied across the board to the layer with the least risk. Simply put the 10% tranche floor is an unnecessary haircut intended to add conservatism to address the same risks that the effectiveness adjustments already more than adequately address.

It's addition also runs the risk that CRT will be deemed uneconomic by the GSEs and encouraging them to retain all credit risk on taxpayer back balance sheets, instead of transferring it to varied and diverse sources of private capital, which have emerged as capable, effective pricing and managing the risk.

Consider for instance, the distribution of the losses that would flow to the so called AH tranche, which covers the 97% retained exposure above the 3% and one coverage detachment point in a typical CRT transaction. Since the M1 tranche is structured to cover stress losses akin to the 2008 financial crisis, the losses that pierce the AH layer would be very remote.

Indisputably, every loan in the underlying pool will not suffer losses if the 10% tranche floor applies to the entire 97% of risk retained in the AH layer.

Of course we are not suggesting that no risk exists within the AH layer, but the proposed 10% floor is superfluous to addressing such a remote risk of loss, particularly when considering the other conservative features included in the framework.

Removing the tranche floor and enhancing credit for CRT, is one of the critical changes needed for FHFA to accomplish its goal of implementing a reasonably conservative capital standard, while maintaining the incentive for a GSE to responsibly manage its risk aggregations by seeding credit risk to private market participants.

This transfer has also proven to be an effective mechanism for efficiently obtaining diverse views of credit risk and market conditions from many third parties, providing useful risk management and pricing feedback to the enterprises, policy makers and market participants alike.

Again, thank you for the opportunity to discuss this important financial tool for the GSEs. For a more robust discussion of our concerns about the proposal's impact on CRT, our supporting analysis, and our recommendations to address them, I refer you to our comment letter submitted August 28th. Thank you. This concludes my prepared remarks.

Moderator: Moving on to the next speaker, Elizabeth LaBerge, National Association of Federally Insured Credit Union. Please go ahead.

Elizabeth LaBerge: Good morning. My name is Elizabeth LaBerge, and I am Senior Regulatory Counsel with the National Association of Federally Insured Credit Unions, or NAFCU.

NAFCU advocates for all federally insured, not for profit credit unions, which in turn serve 121 million consumers, with personal and small business financial service products. We really appreciated the opportunity to provide feedback on the FHFA’s re-proposal of its regulatory capital framework. We're also grateful that you've established these listening sessions to continue to obtain feedback on these important issues.

NAFCU has long supported the use of credit risk transfers, or CRTs, to achieve the goal of allowing Fannie Mae or Freddie Mac, the GSEs, to rebuild appropriate capital buffers and the exit conservatorship. We believe CRT is a critical part of reforming housing finance in the United States. But as others have stated, the re-proposals treatment of CRT, severely disincentivized these transactions in favor of private mortgage insurance, or PMI, which we believe is ultimately harmful to that goal.

Our country is currently suffering a series of destabilizing events, socially, politically, and economically. And as we recover from this pandemic and our economy stabilizes, many of the protections put in place for our homeowners under the CARES Act will likely sense that, resulting in an increase in foreclosures, bankruptcies and potentially affecting property values in hardship regions. And for that reason, it's especially critical that the FHFA ensures the confidence in GSEs and

stability in our housing finance system is maintained into 2021 and the coming years.

As the previous speaker stated, since 2012, CRT has been critical in the improved health of the GSEs. And now is not the time to jettison a tool which is widely perceived as playing a critical role in moving the GSEs into the black and creating stability. So far, CRT is properly working to provide certainty to the GSEs and the American taxpayers, despite our current pandemic stressed market.

The success of CRT is not just a question of perception. CRT solves the concentration problems that private mortgage insurance, or PMI, simply cannot. PMI may move risk off the books of the GSEs, but ultimately that risk is retained in institutions with similar monolines in the housing finance sector. And another sector wide stress event, like the 2008 financial crisis, could render that transfer meaningless and position the GSEs for another bailout.

There's no benefit to reverting to the methods of risk mitigation, which were in place prior to 2008. We know these don't work. In the wake of the 2008 financial crisis of the seven PMI firms used by Freddie Mac, three failed and three were severely downgraded. And for those firms that failed, Freddie Mac received partial or no payment on its claims. And it is absolutely true that increased regulatory controls and improved market discipline has significantly reduced risks in the housing financial sector compared to 2008.

But as we all know, political and economic realities shift rapidly, we're all living that right now. The FHFA should not assume that the concentration risk posed to the GSEs by virtue of their monoline businesses are no longer present or are being mitigated elsewhere in the housing finance system. CRT offers the versification of those holding housing finance credit risk across a range of private investors, ensuring the overall resilience of the American housing finance system.

It’s critical that the FHFA establish a robust capital framework that seeks to prevent another government bailout in the event of a severe stress event, like the 2008 financial crisis, and the transfer of risk to the private sector is important in achieving that goal. However, by discounting the value of CRT so heavily in the re-proposal, the FHFA also disregards the role of CRT in this transitional period until the GSEs can be fully moved out of conservatorship and privatization can be safely and fairly achieved.

So by moving away from CRT so swiftly, while the GSEs must continue to build capital, the re-proposal treatment of CRP delays and complicates the GSEs exit from conservatorship, and unnecessary risks taxpayer money.

CRTs are a safe stable vehicle for transferring credit risk out of the GSEs and the housing finance sector as a whole. The re-proposal's treatment of CRT is a significant course change away from what has been a successful tool in rehabilitating the GSEs up to this point.

In the final rule, the FHFA should adopt the 2018 proposal's treatment of CRT. Further in the future, the FHFA should not depart from that treatment of CRT without significant data collection, testing and reporting of its findings regarding the treatment of CRT, and its wider effects on the health and stability of the GSEs, the cost of credit, and the overall effect on the housing finance sector.

Again, we're very grateful for the opportunity to share our perspective, the perspective of our member credit unions with the FHFA. And I am very happy to answer any questions you might have, or if none, I will yield any remaining time to the next speaker. Thank you.

Moderator: Next speaker, Lisa Pendergast, CRE Finance Council. Please go ahead.

Lisa Pendergast: Good morning and thank you for providing the Commercial Real Estate Finance Council, CREFC, with the opportunity today to share our members' perspectives on GSE reform, the Proposed Capital Rule, and specifically the important role CRT can play in the enterprises exit from conservatorship.

CREFC is certainly grateful to the FHFA for hosting today's event and encouraging this important dialogue amongst all its market participants.

My name is Lisa Pendergast and I'm the Executive Director of CREFC, a trade association comprised of over 300 institutional members representing US commercial and multifamily real estate debt investors, servicers, lenders, including bank and life company balance sheet lenders, securitized lenders, and debt bonds. A market with an estimated $4.6 trillion of commercial real estate debt outstanding.

I will focus my remarks today on the impact of the proposed CRT capital revisions on the multifamily sector.

As a general matter, CREFC members believe that any enterprise capital requirements should be appropriately calibrated for the risk that is held, and should be mindful of not creating outsized advantages or disadvantages for the enterprises relative to private lenders.

Capital requirements appropriately tailored to institutional and systemic risks, and that allow for more even competition across lenders, have broad support among CREFC members.

Specifically, our member support a rebalancing of multifamily lending to allow for heightened diversity amongst lenders and increased private sector participation. Keeping in mind the enterprise's mission regarding affordable housing.

Given CREFC's focus on multifamily rather than single family lending, our members generally view the risk, weight and required capital charges for multifamily as being unjustifiably high, relative to single family. Particularly when multifamily consistently has experienced lower loan delinquencies and generally outperform single family in that regard, including during the financial crisis.

Multifamily credit risk transfer products, or CRTs, represent an important risk management tool that reduces the enterprises and taxpayer's risk exposure by transferring that risk to sophisticated institutional investors in the private sector.

FHFA should avoid unnecessarily penalizing CRTs and preserve the helpful outcomes and benefits of these transactions. Which include one, transparency into market pricing of credit risk on new issue of collateral, which can assist in providing insights toward accurately setting guarantee fees, and two, drawing in upfront private capital to defray risk.

With this in mind, the proposal would significantly dampen the associated capital reduction benefits of CRT transactions via a 10% haircut on capital relief and a 10% capital floor. Moreover the 4% leverage ratio will have a chilling impact on the usefulness of CRT.

Our members were unanimously unclear as to why the agency would reduce the capital benefits associated with structures that have proven to transfer risks successfully, as well as serve as leaders and pathfinders coming out of significant market crises, such as the great financial crisis.

Our members also question why CRTs capital reduction benefit would be reduced now when the GSEs are required to raise a large amount of capital in order to exit conservatorship.

The agency noted that the proposed approach to CRT would deviate from capital neutrality, meaning requiring more capital on the underlying exposures because they are in the form of CRTs, even though the credit risk has been transferred to outside third parties.

Our members would also appreciate a more detailed understanding of the underlying data and analysis used to come to this conclusion as it would, one help us provide more informed feedback, and two, help us to better decide the efficacy of the various CRT structures currently in place, and their methods of transferring risks. Such as selling risk direct to investors or utilizing a combination of risk sharing with lenders, investors, and reinsurers.

In the absence of more detailed data, and again we would much appreciate greater insight into the agency's underlying CRT analytics, we recommend that the agency not pursue a one size fits all approach to CRT capital requirements. Particularly getting Fannie Mae and Freddie Mac's different approaches to CRT, both of which have been effective but will react differently to a one size fits all solution.

Instead we recommend a capital floor that is higher than the current 0%, but lower than the proposed 10%. One that falls in the range between 5% and 7%, which might also encourage greater private sector participation, without an outsized impact on the support of the enterprise’s important role in housing affordability.

Of course, we would very much welcome the opportunity to further explore with you the CRT structures and related capital frameworks that best protect the GSEs and the American taxpayer.

In conclusion, if the proposed CRT capital requirements were not to be revised downward, we are concerned about the onerous and multilayered capital impact on multifamily finance liquidity, as it relates to the enterprises.

With that, I wish to thank you again for the good and important work you are doing on the housing front and for the opportunity to share CREFC’s perspective on the proposed changes to the CRT capital framework.

We certainly look forward to working with you on this important component of housing finance, and once again, appreciate the opportunity to present our views. Thank you.

Moderator: Next speaker, Jeffrey Krohn, Guy Carpenter. Please go ahead.

Jeffrey Krohn: Good morning. This is Jeff Krohn and I lead the Global Mortgage Credit Practice at Guy Carpenter. Guy Carpenter is one of the Marsh & McLennan businesses and e work in the capacity of an intermediary to distribute credit risk from the enterprises, as well as mortgage insurers to well-rated global reinsurers.

First, we want to commend the FHFA for the job it is doing in the wake of COVID-19 to help borrowers and renters who are at risk of losing their home, due to the Coronavirus national emergency. Your work is making a difference in the lives of millions of Americans.

Additionally, in the midst of this challenging backdrop, the FHFA has remained committed to establishing a post-conservatorship regulatory capital framework. And Guy Carpenter recognizes the immense amount of effort that went into drafting the Capital Rule.

Your proposal, though you know not perfect, shows thoughtfulness, and your process shows an openness to consider other points of view. Guy Carpenter's appreciative to have shared its comments in writing and to discuss our perspective here today.

There are a number of directions that we could go this morning. We could discuss how the Rule disincentivizes prudent risk management, or how the leverage ratio as constructed could eliminate the use of CRT, or how the CRT risk weight floor an overall effectiveness adjustment unnecessarily penalize risk distribution.

Or we could address this unreasonable notion that CRT introduces safety and soundness risk to the enterprises. But our written response and those from others in the industry like Arch and RenaissanceRe have addressed these items in detail. And we think, you know, they've all offered constructive alternatives that work within the architecture of the Proposed Rule.

So what we would like to do, and what we think is important, is to step back a little bit this morning and one, revisit some of the key objectives of the Proposed Rule, and then two, ask the question, does it make sense to embrace diverse sources and forms of capital?

It might seem absurd that we would even have to ask this question because the obvious answer is, of course it makes sense to embrace diverse sources and forms of capital. However, the substance of the Proposed Rule does not recognize the benefits of CRT, nor does it embrace these diverse forms of capital.

Additionally perplexing, the Rule even contradicts public statements the FHFA has made that were supportive of CRT.

So let's revisit some of the key objectives in the Rule first. They are as follows. First, end conservatorship of the enterprises. Second, increase the quality and quantity of capital. And third, mitigate procyclicality.

Guy Carpenter enthusiastically embraces these objectives. They make a lot of sense and they should guide the capital framework.

Second, let's examine the question further. Does it make sense that the capital framework embrace diverse sources and forms of capital, and why? Guy Carpenter firmly believes that an appropriate capital framework should include and properly promote diverse sources and forms of capital such as credit risk transfer. There's three points that we would like to make in this regard.

First, CRT works and it supports the counter cyclical mission of the GSEs. It actually distributes the only risks that can really threaten the stability of the enterprises. Maintaining CRT capital will strengthen the stability of the enterprises. A diverse capital base is more reliable and resilient to stress, furthering the enterprises goal of providing stability and mitigating procyclicality.

By reducing potential loss and responding in times of stress, CRT serves an effective form of countercyclical capital. The 2007 and ‘08 crisis provide -- proved the danger of relying on one source of capital and that was equity capital. Reliance on a single source of capital didn't work back then, and it won't work now.

A diverse capital framework starts with, and should promote access, to different pools of capital that includes equity capital, and CRT capital through fixed income and re-insurance markets. Why would you want a capital framework that doesn't encourage access and competitive sources of capital from the non-equity and re-insurance markets? It makes no sense.

Those fixed income and reinsurance markets combined are almost 50% greater than the size of the equity markets. Diversity of capital creates competition, and it brings multiple forms of capital under the GSEs and the enterprises tent to ensure that if a particular economic cycle stress, stress is one of those three forms of capital, the enterprises will have other loss absorbing forms of capital to fall back on.

So second, prudent and appropriate credit for CRT capital creates a bridge and enhances the ability of the enterprises to emerge from conservatorship, and reduces costs to homeowners by reducing the enterprises overall cost of capital.

The ability to access CRT capital reduces the amount of equity capital the enterprises will have to raise, which is already many times the level of the largest IPO in history. Moreover, CRT creates a more compelling business model to prospective investors, increasing the demand and attractiveness of equity capital, by lowering enterprise capital costs, reducing volatility, and improving potential investor returns.

The lower capital costs created by using an efficiently designed CRT program, ultimately translates into lower costs for the US homeowner in greater affordability. The alternative, sole reliance on equity capital, will require the enterprises to increase their guarantee fee to attract necessary equity capital.

Third, maintaining CRT capital creates incentives for the enterprises and their shareholders to operate in a prudent manner. CRT investors and reinsurers have significant skin in the game and serve a valuable oversight and surveillance function by providing a market signal of increased risk.

There was no market feedback mechanism in 2007, and a short term mentality encouraged by interest of equity shareholders overwhelmed the long-term safety and soundness of the enterprise. Let's not let that happen again and not overlook the value CRT participants can provide to assure long-term safety and soundness of the enterprises.

The three benefits of CRT I just mentioned don't receive any recognition or capital uplift in the Rule, but we believe they must be put into proper perspective as the FHFA finalizes the Rule.

The business model of the enterprises has to evolve. It cannot revert to the pre-crisis model where the enterprises were reliant on a single source of equity capital. The capital framework must embrace multiple

forms and sources of private capital, including foundational equity capital, complemented by CRT capital from fixed income and re-insurance markets.

Doing so supports ending the conservatorships responsibly, it increases the quantity and quality of capital, and it strengthens the countercyclical mission of the GSEs.

Thank you for your time this morning. Guy Carpenter remains committed to engaging in productive discussion and solution seeking on this extremely important topic for our country and the economy.

Moderator: Next speaker, Joseph Monaghan, Aon. Please go ahead.

Joe Monaghan: Good morning and thank you for the opportunity to offer our thoughts today. My name is Joe Monaghan and I'm the CEO of Aon's Public Sector Partnership, a dedicated team focused on government clients, including the enterprises.

The FHFA's 2020 Proposed Capital Rule has good objectives. And Aon agrees with its desire to transition the enterprises from conservatorship in a safe and sound manner that protects the US taxpayer, by increasing the quantity and quality of capital underpinning them, so that they can fulfill their mission across the housing cycle.

Aon's worked closely with the enterprises and the FHFA to build multiline insurance based credit risk transfer since 2012. The enterprise has selected Aon as their broker to help create the agency credit insurance structure, ACIS, credit insurance risk transfer, CIRT, multifamily credit insurance pool, MCIP, and multifamily credit insurance risk transfer, MCIRT programs.

These transactions shifts risk away from the enterprises to a diversified group of highly rated and well-capitalized multiline insurance and reinsurance companies. And we're pleased to highlight that this market has functioned even during the upheaval generated by the COVID-19 pandemic.

Between March 15th and August 31st of this year, we executed five different mortgage reinsurance deals on behalf of mortgage insurers and in enterprise. And that secured an excess of $1.8 billion of CRT capacity.

We believe that CRT plays an important role within a strong capital framework. We acknowledge and we agree with the FHFA that equity must form the foundation of any prudent recapitalization of the enterprises. And that CRT should not receive dollar for dollar credit equal to equity within that framework. Reasonable haircuts are appropriate.

CRT must also be economically a creative for the enterprises. And the contract should not be overly complex and threaten the ability for the enterprises to collect recoveries in a stressed environment. Further, the structures should be geared to providing real risk transfer for a range of potential stresses, especially during the period of most significant exposure, which is generally in the first three to six years post-loan origination.

The good news is that CRT, since it was designed incorporating the lessons learned from the great financial crisis, meets all of these important requirements today. And with some modest adjustments to the proposed framework, we believe that CRT will continue to create value for the enterprises and protect taxpayers.

The reinsurance industry has come together over the past several months to examine FHFA's proposal with the goal of providing meaningful and hopefully constructive feedback that will be useful to FHFA as it continues the important work necessary to finalize a robust framework.

As others from the reinsurance industry have, and will touch on during this session, we think there are five main things to focus on regarding the FHFA's proposed framework.

One, the consequences of the OEA adjustment and minimum risk wage tranche outweigh the benefits, and there are alternative ways to mitigate those concerns. My colleagues at Arch, David Gansberg, touched on that earlier.

Second, CRT is a valuable tool and it protects and it preserves equity, and it will be an important tool to build the significant level of foundational equity required to support the GSEs. Jeff just did a great job outlining that.

Leverage ratio, it's a useful tool in establishing minimum capital levels, but it should be adjusted as not to overwhelm the utility of diversified capital sources. There are different ways to make those adjustments.

You'll hear about that from some of our colleagues later. And reinsurers are a very strong counterparty. They've made significant investments in the ability to assess mortgage credit risk and exposure, and they have a buy and hold mentality so they can prudently serve clients.

But the fifth component is that risk based capital should be the driver across the majority of outcomes, because it aligns capital and risk, and it incentivizes prudent long-term credit policy. We want to focus on that point here today.

We believe that the risk based capital framework should aspire to be as sensitive as possible to the underlying risk of the enterprises so that it appropriately incentivizes prudent risk management and disincentivizes improper levels of risk accumulation.

Risk weight floors and capital buffers, they may individually appear reasonable, but because they tend to be blunt instruments, they should be evaluated carefully and in consideration of the overall responsiveness of the RBC framework to the underlying risks. Under the 2020 Proposed Capital Rule, almost 60% of the RBC requirement is driven by other buffers or risk weight floors.

As an alternative, we've outlined this in detail in our response letter, we would suggest a single buffer, sized to risk weighted assets. It would be sufficient to account for any residual model risk and allow for additional capital to ensure the enterprises are going concerns through significant macro-economic stress.

We recommend consolidating the stress loss, the stability, and the countercyclical buffers into a single RBC buffer, which should be sensitive to risk weighted assets. This buffer would need to be calibrated, and we have provided our view of potential level in our written response for further consideration and discussion by the FHFA.

Additionally, there are adjustments we believe could be made to the risk based capital treatment, to make the more appropriate -- to make the risk based capital treatment more appropriate for multifamily risks.

First, a multiplier for targeted affordable housing properties should be established to properly reflect their lower level of risk.

Second, a multifamily specific countercyclical adjustment should be incorporated into the framework.

Finally, the loss timing effectiveness adjustment should be adjusted to be based on weighted average maturity for multifamily loans.

While we believe in the utility of diverse sources of capital, we agree with the FHSA that equity must be the foundational component to the enterprises capital composition.

Further, equity capital should increase with risk. And though we propose using the leverage ratio requirement to establish a minimum level of equity, we believe a further adjustment within the risk based capital framework is needed to protect against an over reliance of non-equity capital, especially as risk increases.

To achieve this, we propose a tier one capital requirement set at 45% of the pre-CRT RBC requirement. We call it the capital mix requirement. We believe that this could be an improvement over the leverage ratio since it scales up when macro-economic conditions deteriorate.

Further, it acts as a ceiling, limiting the amount of CRT that could be used to satisfy additional capital requirements as RBC requirements increase. It's just one suggestion.

Many thoughtful suggestions have been made by other organizations. It's been great to see how engaged market participants have been on this important topic. We believe that collectively, these comments provide the FHFA with a variety of suggested improvements and considerations for adjusting the risk based capital framework.

As has been mentioned, achieving the targeted levels of equity will be a multiyear process and will likely require complimentary capital sources to reduce taxpayer loss exposure during the transition to sufficient equity levels. Given our belief in the benefits of diversified capital sources, the proposed adjustments to the capital credit for CRT are counterproductive to that goal.

Our experience and analysis indicate that, if the FHFA adopts these recommendations, they can achieve a robust framework that aligns risk and capital, appropriately incentivize prudent long term credit policy, and preserve sufficient equity through the use of diverse sources of complimentary capital to sustain the enterprises through any future stress.

Thank you for your time and the opportunity to provide our thoughts on this important topic.

Moderator: Next speaker, Stockton Williams, National Council of State Housing Agencies. Please go ahead.

Stockton Williams: Thank you and good morning. The National Council of State Housing Agencies is pleased to present to the Federal Housing Finance Agency, on behalf of the State Housing Finance Agencies, it represents.

The State HFAs are the centers of the nation's affordable housing delivery systems in their State. They were created by their state governments to address their state's home ownership and rental housing needs, and to be the primary mission based sources of mortgage financing for lower income households and affordable rental housing developers.

State HFAs, generally serve borrowers and market segments, the typical Fannie Mae and Freddie Mac seller servicers do not. They're also an important source of support to affordable multifamily housing.

The enterprise has programs and activities to provide a significant support to state HFA lending over the years. And the agencies have financed affordable home ownership and rental housing at significant scale in their markets.

In turn, the enterprises have benefited from high quality goals rich loans they've received and might not otherwise have been able to access through their partnerships with state housing finance agencies, enabling them to meet the full set of responsibilities in their charter.

The National Council of State Housing Agencies and our members are greatly concerned that the Proposed Capital standards, including their treatment of the credit risk transfers, could jeopardize the enterprise support for affordable single family and multifamily mortgage finance by making these products, which are needed now more than ever, prohibitively expensive.

The Proposed Capital standards have serious flaws that will jeopardize Fannie and Freddie's ability to meet their vital affordable housing mission. This will hurt the ability of state housing finance agencies and others to address key needs in both the home ownership and rental market.

In crafting the Proposed Capital standards, FHFA says it was driven by the GSEs statutory mission to provide stability and ongoing assistance to the secondary mortgage markets across the economic cycle.

While this is an important part of the GSEs public purpose. FHFA does not apparently consider the GSEs other public duties. Namely, to support activities relating to mortgages on housing for low and moderate income families involving a reasonable economic return that may be less than the return earned on other activities, and help foster access to credit in underserved markets.

In general, FHFA is proposing to significantly increase the capital Fannie and Freddie must hold for many of the loans they purchase and guarantee, especially homeownership loans that often serve low and moderate income borrowers.

These loans would get walloped by the layering of risk multipliers that FHFA proposes. For example, for higher original LTV loans, and for lower FICO loans or subordinate financing. Including down payment assistance, which is so necessary for credit worthy borrowers who have not been able to save for a down payment. These standards would also increase capital charges on a variety of affordable multifamily loans.

FHFA's treatment of credit risk transfers is a good example of how the credit standards, capital standards rather, will increase the cost of affordable housing lending, while doing little to protect the enterprises from risk. In fact, the framework will discourage the use of CRT, as you've already heard this morning, resulting in a greater concentration of credit risk in the enterprises.

Since 2013, both enterprises have increased their use of CRTs considerably. According to Moody's, "Over the last few years, the GSEs have transferred about two thirds of their overall single family credit risk into the CRT market, which takes approximately one fourth of all mortgage credit risk originated in the market today." CRTs are why they regard it as tremendously successful. 2018 paper by the Federal Reserve Bank of New York found CRTs improve the stability of the housing finance system and advanced a number of important objectives of GSE reform.

CRTs can also help the GSEs operate more efficiently. Also, as you've heard today, by providing real time market feedback on the perceived risk of their loan.

The extent that affordable multifamily and single family loans are treated as riskier, under FHFA's proposed framework, CRTs would have allowed the GSEs to offload a significant chunk of that risk, decreasing

their exposure to potential losses and lowering their capital requirements, had FHFA not disincentivized their use.

Lower capital requirements help the GSEs keep GPs lower than they might otherwise be, which also makes their single family and multifamily mortgages more affordable.

FHFA's Proposed Rule would substantially reduce the capital relief the GSEs realized from CRT transaction. So much so we believe that it could eliminate the GSEs use of CRTs entirely and jeopardize their support for affordable single family and multifamily loans. Specifically the proposed framework would set a floor that requires the GSEs to maintain at least 10% capital for all CRT transaction, regardless of their underlying risk.

In addition, FHFA also proposes that when credit risk is laid off to a third party, through a securitization, the GSE must nevertheless calculate its risk weighted assets as if 10% of the risk sold off were still on its balance sheet.

In other words, if third parties purchased $1 billion of mezzanine security, the GSE must still act as if $100 million was not effectively transferred and hold capital against this amount.

According to FHFA zone analysis, the proposed framework would lower the capital cushion that CRTs provide the GSEs by nearly 50%. Interestingly, both Fannie and Freddie note in their comments on the Proposed Capital framework, that the proposed new standards will make it infeasible for them to continue most of their CRT transactions, which seems counter to FHFA's overall purpose of reducing the systemic risk that each GSE poses.

These requirements will greatly increase the GSEs costs in engaging in CRT transaction. When combined with the administrative costs associated with CRTs, such transactions will simply be uneconomic for the GSEs. If the GSEs, are unable to utilize CRTs they'll have to hold new credit risk, and hence more capital on their books. This will prompt the GSEs to increase GPs and/or tighten their underwriting standards, decreasing affordability.

Furthermore, and finally, the new capital standards for CRTs could actually weaken the GSEs financial position by forcing them to hold more credit risk on their books. The National Council of State Housing Agencies joins many of its fellow housing advocates and trade association, in suggesting that FHFA rescinds or simply dramatically

overhaul the Proposed Capital framework for CRTs and develop a new, more holistic approach that better reflects the risks such transactions pose to the GSE that specifically takes into account their critical affordable housing mission. Thanks very much.

Moderator: We are running a bit ahead of schedule, so we are going to skip the break and move on to the next speaker Ed DeMarco, Housing Policy Council. Please go ahead.

Ed DeMarco: Thank you for this opportunity. My name is Ed DeMarco and I appear today on behalf of the Housing Policy Council.

It is safe to say however that my support of the credit risk transfer program goes back to its very beginning. HPC's formal comment letter includes a lengthy explanation of the value we see in credit risk transfer as a critical risk mitigant and as a meaningful source of loss absorption capacity.

We include detailed analytics of why we think the Proposed Rule would render CRT ineffective in the enterprises capital management strategy, thereby driving up their cost of capital.

My goal today is not to review the finer points on CRT covered in our letter, and I might add, covered quite well by other commenters, including several we've already heard from this morning, such as Arch, Guy Carpenter and Aon.

Instead, I want to explain the value of CRT as a source of risk oversight and loss absorption, thereby providing context to why FHFA should rethink its treatment in the Capital Rule.

Fannie Mae's and Freddie Mac's failures in 2008 resulted from far too little capital and far too much risk. The GSEs acted as if their nationwide portfolio diversified away mortgage credit risk. We learned otherwise. We suffered the consequences of concentrating $5 trillion of mortgage credit risk on two balance sheets.

But here's a key point. It is not just that Fannie and Freddie's capital requirements were too low, although they clearly were, it was that they were allowed to concentrate all that risk on their two balance sheets. An oversight of the risk management from this arrangement was left to their equity investors.

Only two risk management teams, one at each company, concerned themselves with mortgage credit risk. MBS and debt investors, correctly it turns out, perceived they did not bear credit risk and thus did not monitor or price for this risk.

This is what makes the credit risk transfer program essential for the secondary mortgage market going forward. It is not just that FHFA must increase the GSEs capital requirements to be on par with other regulated entities holding mortgage credit risk, it is that we must diversify those sources of capital and broaden the universe of institutions and investors that serve as bearers of credit risk, organizations that can expand and enhance the monitoring and evaluation of mortgage credit risk, so we are not reliant upon the risk management judgment of just two companies.

As our comment letter, and many other comment letters point out, if implemented as proposed, the Capital Rule would provide so little capital relief to the enterprises from CRT, or put another way, make obtaining that capital relief so costly, it would not be used broadly.

That would bring us back towards the pre-CRT world where the GSEs retained virtually all the credit risk on the mortgages they securitized. That produces three things, enormous systemic risk, few evaluators of credit risk and limited market pricing of credit risk.

In contrast, a world in which the enterprises receive appropriate capital relief from CRT would result in greater scrutiny of mortgage credit risk, in much greater dispersion of that risk in the market.

Let me highlight three benefits. First, a considerable reduction in systemic risk, because credit risk would be distributed across numerous investors and transactions. If for no other reason than this, FHFA as a prudential regulator and a member of FSOC, should find tremendous value in CRT.

Second, each CRT transaction has multiple investors focused on the loans in that pool. By incentivizing or requiring CRT across virtually all pools, as if FHFA's practice today, no pool goes without its own scrutiny. Changes in risk characteristics will be noticed and priced by the market. Examples of this happening were noted in several comment letters, with more eyes evaluating both the level and change in risk, the likelihood of an adverse and systemic outcome from the risk management mistakes by the two GSEs is greatly diminished.

Third, by having to go into the market to purchase loss absorption capacity via CRT on every pool, FHFA and the GSEs receive ongoing market feedback on the singular risk that is central to the GSEs business. And this feedback is far more transparent than when the risk is warehoused by the GSEs and backed by equity capital that is rarely issued, and whose market pricing is affected by many factors.

In the Proposed Rule, FHFA observed that CRT has less loss absorbing capacity than equity because it is limited to certain risks on certain pools.

Fair enough. But that observation does not do justice to the loss absorbing capacity CRT does have for what is the central risk to be managed, mortgage credit risk.

If CRT were randomly executed on just some of the book of business, that would be a concern. However, FHFA set a 2019 scorecard goal for the enterprises to have CRT cover at least 90% of credit risk associated with all newly acquired single family mortgages in targeted categories.

Since the loans not subject to CRT also are the least risky, such as very low LTV loans, CRT covers the vast majority of mortgage credit risk held by the enterprises, making it functionally capable of covering almost all potential unexpected single-family credit losses.

Moreover, the practice has been, and should remain, that the amount of risk transferred from each pool should well exceed projected severe stress losses. Model risk associated with projecting those stress losses, and other FHFA concern, is borne mostly by CRT investors, not the GSEs.

Let me address two other concerns FHFA raises about to CRT. First, there may be temporary periods as we saw this spring when market volatility disrupts the normal functioning of the CRT market. Yes, that can happen. Such resetting of risk assessments when circumstances change is a normal and desirable feature of private markets.

Our long history of credit market performance shows such episodes are infrequent and brief, and they are why FHFA proposed a stress capital buffer and other buffers. But when market disruptions do arise, the existing CRT is there to absorb losses on the existing business.

Second, FHFA argues that the sum of all tranches, both retained and sold by a CRT, should require more capital than the equivalent underlying risk. HPC does not take issue with that principle.

However, we object to the excessive and overlapping haircuts and adjustments that collectively treat CRT as an added risk to the enterprises rather than a risk mitigant. These adjustments take three forms, a 10% risk weight floor, a series of effectiveness adjustments that includes a 10% haircut on all risk transferred effectively assigning that risk back to the enterprise, and a set of operational criteria. Of these, the most consequential and least defensible is the fixed 10% risk weight floor.

In the end, the treatment of CRT in the capital framework is not an either or question. The goal should be to maintain prudent levels of both equity capital and CRT, that would enable the enterprises to benefit from the unique loss absorbing and risk mitigating features of both.

We believe CRT acts more like permanent capital than FHFA gives it credit for in the Proposed Rule. A balance between common equity, other capital and CRT promotes the effective deployment of capital at the most efficient cost and benefits home buyers in the form of lower mortgage rates.

Additionally, it fosters a smoother emergence of the enterprises from conservatorship. Punitive discounting of CRT capital relief disrupts that efficient capital allocation and raises borrowing costs.

Finally, the Proposed Rule notes FHFA's intention to halt lender risk share CRT. HPC requests FHFA to reconsider that decision and our letter sets forth our reasons in detail. FHFA's goal should be a deep liquid and competitive market for mortgage credit. Limiting market participants limits competition and hinders that outcome. Thank you.

Moderator: Moving on to the next speaker, Brian Stoffers, Mortgage Bankers Association. Please go ahead.

Brian Stoffers: Thank you. Can you hear me?

Moderator: Loud and clear?

Brian Stoffers: Hello? Can you hear me?

Moderator: Brian, you're coming in loud and clear.

Brian Stoffers: Okay. Thank you. All right, well thank you for this opportunity. The Mortgage Bankers Association has been a consistent supporter of the GSEs credit risk transfer programs in both the single family and the

multifamily businesses. And MBA has several principles for a successful credit risk transfer program I would like to discuss those.

First, the GSEs should offer a diverse set of credit risk transfer mechanisms for both single family and multifamily, and both are counterparty focused and capital markets focused.

We believe that different mechanisms work better for different types of companies or under different market conditions, and we believe that greater diversity and CRT mechanisms support a more vibrant and resilient housing market.

It's our opinion that the FHFA should not put a thumb on the scale, so to speak, towards one particular credit risk transfer mechanism, for instance, counterparty versus capital markets in the Capital Rule.

The GP should have room to innovate and experiment and potentially take different approaches from each other. We believe that capital relief should be commensurate with the level of protection that is provided. And that credit risk transfer should be a consistent part of the GSEs business models, not an activity that's undertaken only occasionally or under very specific market conditions. It should be the norm and not the exception.

The capital framework is an important mechanism by which the FHFA should encourage greater use of credit risk transfer by the GSEs. And the proposed framework unfortunately provides treatment that is far too punitive and really would discourage the widespread use of CRT.

The MBA has specific recommendations. One, we believe that the 10% risk weight floor should be reduced significantly and targeted more narrowly.

We believe that the financial strength standards for mortgage insurers and reinsurers should be made more transparent.

Capital relief should be provided for mortgage insurance on single family loans with LTV ratios below 80%, as well as for deeper mortgage insurance coverage on loans with higher LTV ratios.

And for multifamily counterparties the overall effectiveness adjustment, in other words, the OEA, is functionally duplicative for counterparty haircut for tax lenders, and therefore should not be applied.

The framework should be more thoroughly recognized in situations in which capital markets transactions such as the Freddie K deals remove risks associated with ongoing cash flows.

And the framework should be more thoroughly recognizing the situations in which capital market transactions, such as Freddie, we've already discussed that, have ongoing cash flows.

In summary, I would say that the GSEs are going to be safer, more reliable institutions that can serve counterparty roles if they effectively distribute mortgage credit risk, rather than operating as holders of concentrated mortgage risk. And the Capital Rules, wherever feasible, should encourage this market conduct. Thank you for this opportunity and time.

Moderator: Let me ask the next speaker, RJ Shea, RenaissanceRe, please go ahead.

RJ Shea: Hello all. Before I begin, I would like to thank everyone for listening and I would like to specifically thank the FHFA for providing this open forum for comments.

My name is RJ Shea and I'm the Senior Vice President at RenaissanceRe, a global multiline re-insurance and insurance company. We have been an underwriter of mortgage risk globally for over a decade and an active leading participant in structuring and pricing US mortgage reinsurance transactions since the first transaction placed following the global financial crisis in 2013.

We agree with the FHSA on the need for an appropriate regulatory capital framework for the enterprises and on the broad principles articulated in this Capital Rule proposal.

However, there are elements of this Rule that will impede the enterprises, both from exiting conservatorship and from fulfilling their mission to support a competitive, liquid, efficient and resilient national housing finance marketplace.

As the Department of the Treasury cautioned in September of 2019 Housing Reform Plan, the enterprises need requirements tailored to the risks they pose.

Furthermore, given the importance of the housing finance system to economic stability changes should take careful account of the risks

posed by the transition. And this generally counsels in favor of preserving what works in the current system.

As others from the insurance and reinsurance industry have touched on during the session, there are five main themes, we at RenaissanceRe are most focused on regarding the FHFA's Proposed Capital framework.

Number one, risk based capital should be the driver across most economic outcomes because it properly aligns capital and risk.

Number two, CRT is a valuable product that helps preserve equity and will be an important tool to build a significant level of equity required to support the GSEs out of conservatorship.

Number three, the impact of the OEA adjustment and minimum risk weight tranche outweigh the benefits, and there are alternative ways to mitigate those concerns.

Number four, reinsurers are strong, highly rated counterparties that have made investments and their ability to model manage an aggregate mortgage credit risks to ensure they serve clients through credit cycles.

And number five, the leverage ratio is a beneficial tool in establishing minimum levels of capital, but should be adjusted as to not overwhelm the utility of diversified sources of capital.

Given the time allocated my comments today will focus on this final point, the leverage ratio.

As described by the FHFA in connection with the 2020 Proposed Rule, the proposed 4% leverage ratio is intended to be analogous to the 5% leverage ratio required a federal home loan banks. The material increase over the FHFA's 2.5% leverage ratio assessment in 2018 results in an oversized and counterproductive leverage ratio for a couple of reasons.

A, it does not fully take into account the differences between banks and the enterprises and B, it does not include any credit for CRT. Therefore falling short of reflecting the real world benefits of CRT and reducing the risk to the enterprises by distributing that risk to diversified private sources of capital.

Although the FHFA asserts that a sized to leverage ratio to approximate that required of banks, if like for like standards are applied, a leverage

ratio tailored to the enterprises should be meaningfully lower than 4% for the following reasons.

First, the enterprises' product is inherently less risky than bank products, particularly in the wake of the FHFA's efforts to reduce the enterprises exposure to their highest risks. This is evidenced by three comparisons, a calculation of risk weighted assets, market price comparisons, and historical loss performance comparisons.

On the comparison of risk weighted assets, the FHFA's risk weight for the enterprises book of business as of 3Q '19 was 27.8%. It was 21% prior to the application of the 15% minimum risk weight floor. This is less than half and was approximately one third of the average CIPI bank risk weight of 60% at the end of fiscal year '18.

This comparison also holds under the Basel framework. As under Basel, the risk weight for whole loans is 50% for banks and 20% for MBS carrying an enterprise credit guarantee. As a result, the residual risk of credit losses to the enterprises can be interpreted as at most 30%, which is consistent with the current FHFA risk weight, prior to the application of the 15% minimum risk weight floor.

On the comparison to market prices, the FHFA approved guarantee fees charged by the enterprises to account for the credit risks they retain is less than one fourth the price for a 30 year fixed rate mortgage. This is indicative of the lower level of risk retained by the enterprises relative to commercial banks, reflecting both the lack of interest rate risk, which is match funded via MBS and lower credit risks due to tighter underwriting standards.

On the comparison of historical loss performance, as demonstrated by Fannie Mae's, former Vice Chairman and CFO, Tim Howard, the enterprises historical credit loss rates have been a fraction of commercial bank loss rates for single family mortgages over the last 30 years, including through the global financial crisis.

For the period between 1992 to 2019, the credit losses for Fannie Mae single family mortgages were one sixth that of US commercial bank loan portfolios.

Even when focusing on the years during and following the global financial crisis, between 2008 and 2019, this loss level was still 70% lower than losses suffered by commercial bank loans.

Compared to banks' varied and opaque products, the enterprises essentially offered a single transparent product that is fully subject to FHFA oversight. The enterprises provide loan guarantees and generally retain a single material risk.

This contrasts with banks and to the bank leverage ratio, which is designed to protect against three primary risks. Interest rate risk, liquidity risk, and credit risk. For the enterprises, the majority of interest rate and liquidity risk is eliminated by the matching of assets via mortgage securitization, primarily leaving only credit risk on the enterprises books. This limited exposure substantially reduces the like for like requirements that should be considered when tailoring the leverage ratio to the enterprises.

The enterprises risk is well understood, as the enterprises benefit from a wealth of performance data generated during the 2008 financial crisis that provides insight into default risk. As a result, the enterprises have portfolios that are significantly more transparent to observe and subsequently more straightforward to regulate than banks.

As the Urban Institute has calculated, the capital required by the leverage ratio exceeds the cumulative realized losses in the global financial crisis, even though the enterprises business model and portfolio is now materially less risky. As the enterprises have minimized their exposure to product risk and refocused their efforts on solely assuming borrower risk.

This is further evidenced by the current forbearance take up rate of the enterprises portfolio, which is approximately 45% of the take-up rate currently experienced by the PLS loans.

In summary, over-sizing the leverage ratio relative to a suitable risk based capital framework will have material adverse impacts on risk management decisions. As evidenced by the FHFA's acknowledgement that the leverage ratio will apply from day one, the leverage ratio ceases to act as a backstop and will apply even in some of the most benign economic scenarios.

According to Freddie Mac's analysis, as part of their comment letter to this Proposed Capital Rule, looking back over the last 18 years, the proposed leverage ratio 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 the leverage ratio does apply. two adverse incentives are created. Firstly, the enterprises will be penalized for, rather than encouraged to, spread risk to the private sector via a CRT because they receive no capital credit for CRT to offset the fixed obligations that arise from purchasing the CRT product.

Secondly, the enterprises will be encouraged to take on additional risk to boost their return on equity because the leverage ratio does not differentiate upon the riskiness of the assets assumed.

We would encourage the FHFA to consider removing the 1.5% prescribed leverage buffer amount and return the leverage ratio back to a level which does not completely disincentivize the enterprises use of CRT.

For our fulsome and complete response to this Proposed Capital Rule, please refer to our previously submitted comment letter. Thank you again for providing this open forum for comment.

Moderator: The next speaker is Frank Nutter, Reinsurance Association of America. Please go ahead.

Frank Nutter: This is Frank Nutter, I'm the President of Reinsurance Association of America and thank you for this opportunity. The Association represents the full value chain of support for the mortgage market of brokers, mortgage insurers, and reinsurers.

Reinsurers, as you've heard from a number of speakers have been very supportive of the CRT market from its inception when the FHFA required the GSEs to engage in CRT transactions. And it continued to be a major source of support for the capital structure of the GSEs in conservatorship.

As noted by Joe Monahan of Aon previously, even in this extraordinary year, the reinsurance marketplace has continued to support new CRT transactions.

And as mentioned by Ed DeMarco in referencing the value of engaging the private sector and looking at these, the capital structure, both reinsurers and reinsurance brokers have built out analytics and made significant investments in their ability to assess mortgage credit risk, to ensure that they manage their long term buy and hold positions prudently to serve clients through financial cycles.

The FHFA's Proposed Capital Rule we believe has laudable goals, and a workable framework. But as proposed, the Rule would unfortunately diminish the value of and the role of CRT and based on our assessment would effectively eliminate CRT from the GSEs, the GSEs would be disincentivized from entering into these transactions.

We were encouraged that previously in 2019 that the Administration in its reference to housing finance reform supported the CRT role in support of the GSEs.

And frankly, they were very supportive of FHFA's own report in April of this year, which really referenced three things. It highlighted the value of engaging a group of diversified reinsurers in the CRT program, noting that they are not engaged in taking on risks that is correlated to the housing market.

Secondly, the report noted that the reinsurance portfolio is with highly rated reinsurers. And third that the CRT program reduces counterparty reimbursement and correlation risk.

I'd like to comment on any concerns that the FHFA may have about counterparty risk. Reinsurers are fully subject to solvency and financial regulation in the same manner as insurance companies. And the CRT transactions are either fully or substantially collateralized.

These two factors, regulation and collateral make counterparty risk de minimis. Reinsurance is a risk management tool commonly used in the private sector by insurers and as inherently countercyclical.

Reinsurance also supports government insurance and credit programs at both the state and federal level. At the federal level, it's notable that the national flood insurance program and the export import bank both have risk transfer programs into the reinsurance sector.

Reinsurance also supports the state programs, the California Earthquake Authority, the Florida Hurricane Catastrophe Fund, Florida citizens, Louisiana citizens, and a number of other state legislative programs that rely upon the financial structure that the reinsurance community provides.

Reinsurance reduces the volatility of prevential formats in government programs, both at the state and federal level, and certainly with the GSEs. In the wake of major financial events, reinsurers have historically and proactively taken on additional risk. The CRT program is a good

example of that as a number of reinsurers on the CRT program has grown over the years to over 40 participants.

Our letter documents the significance equity capital supporting reinsurers, and further documents the addition of capital to the reinsurance sector following major insured loss events.

Reinsurance is a proven, reliable source of capital support in both the private and public sectors. Our letter and that of our members, Aon, Marsh, Guy Carpenter, Arch, and RenRe, provide recommendations for adjustment and the calculation of capital needed by the GSEs in ways that will encourage utilization of CRT capital as a diversifying capital source and a bridge to the equity capital needed by the GSEs.

Thank you for this opportunity to address these matters.

Moderator: Next speaker is Andrew Rippert, Portum Trust. Please go ahead.

Andrew Rippert: Good morning and thank you for the opportunity to provide additional commentary on the Enterprise Regulatory Capital Framework. My name is Andrew Rippert. I am the Founder and Chief Executive Officer of Portum Trust.

Portum Trust facilitates mortgage credit risk transfer to private capital through the application of market leading analytics and loan level data to underwrite, price and surveil mortgage loans in the agency and the non-agency markets.

Portum Trust appreciates the work done by the FHFA to address areas highlighted in response to the 2018 Proposed Capital framework. For example, the procyclicality inherent in the 2018 proposal. Through implementation of market to market LTV ratios, or loan to value ratios, and a countercyclical capital buffer, we believe the FHFA has made meaningful and durable changes to the Proposed Capital regime.

Private capital supporting the US housing finance system comes in multiple forms, including equity capital, senior unsecured debt, and multiple forms of credit risk transfer, including private mortgage insurance, the issuance of capital debt market instruments, such as Connecticut Avenue Securities, or CAS Bonds, and Freddie's Stacker Bonds, and reinsurance credit risk transfer programs such as Freddie Mac's ACES program and Fannie Mae's CERT program.

Since 2013, when Fannie and Freddie began their CRT programs in earnest, the diversity and amounts or private capital has grown significantly, and now includes a large number of institutional investors and reinsurers.

Prior to 2013, virtually all agency single family mortgage credit risk was assumed and held by the GSEs and the private mortgage insurance industry. Both the GSEs and the private mortgage insurers are leveraged to monoline mortgage guarantors, whose financial strength is highly correlated with each other and non-diversified.

Therefore, we believe the CRT programs developed over the past seven plus years have meaningfully strengthened the US housing finance system and reduce the likelihood of a taxpayer backed rescue during times of economic stress.

The Proposed Capital framework, and more specifically the backstop leverage ratio and CRT treatment, if implemented as presented in the plan, has the potential to making -- make the raising of equity capital by the GSEs, or a newly chartered guarantor, much more challenging without a meaningfully higher guarantee fee, which would result clearly in higher cost to borrowers.

We also think it has the potential to drive a significant volume of business from the agencies to the Federal Housing Administration, and thereby further expose you as taxpayers to housing finance risk.

For example, our analysis of loans with LTVs in excess of 80%, suggests that approximately 14% of those high LTV loans would be cheaper to fund for borrowers through an FHA loan versus an agency loan. So 14% of that business that's currently with the agencies and private mortgage insurers, we believe has the potential to shift over to the FHFA.

And finally, we think that the Rule as presented, incentivizes the GSEs to concentrate their portfolios in the highest risk loans given the backstop leverage ratio.

We believe that through relatively modest changes to the Proposed Capital Rule, such as a lower risk weight floor on the senior retained tranche of a CRT transaction, and a lower backstop leverage ratio, think the FHFA will still achieve its intended objective of a more resilient and stable GSE housing finance system, that is able to withstand significant levels of economic stress.

Also through coordination of housing policy between the GSEs and the Federal Housing Administration, the transfer of mortgage loans and the associated credit risk from GSE execution to FHFA execution can be avoided without a meaningful increase in cost of mortgage credit for borrowers.

The proposed risk weight floor on the senior retained CRT tranche disincentivizes the use of CRTs by the GSEs in all but nearly perfect market conditions where CRT spread levels are at their tightest.

For example, with the 10% risk weight floor, our analysis indicates that the GSEs would have issued CRT less than 25% of the time over the history of the CRT programs.

Further, loss experience through the great recession indicates that if 10% floor is overly conservative. That said, Portum Trust believes that a risk weight floor is necessary and appropriate for the senior tranche, because it is indeed exposed to catastrophic levels of credit losses.

Our analysis indicates that an adjustment of the risk weight floor on the senior retained tranche to the 3% range is equally as effective in providing security, and strikes the sustainable balance between the use of CRT and equity capital while continuing to support reasonable costs of mortgage credit for borrowers.

I would like to now comment on the proposed 4% backstop leverage ratio. When you look at the capital charge that exists in the risk based grids, and take into the consideration that the mortgage loan originations for the more risk remote loans, a 2% backstop leverage ratio appears much more reasonable.

It's supported by historical results and motivates a more appropriate balance between equity and CRT capital. This is borne out by comparing a 2% ratio to the GSEs loss experience for risk remote loans, that is loans with credit scores 720 plus range, and LTVs less than 80 to 85 range.

We observe that the actual loss experience for the worst performing vintage year, 2006 through the great recession, is in fact less than 2% for these risks remote loans.

So again, what we did is, we looked at in depth, the capital charge by the risk weight grids for those more risky loans, risk remote loans, compare that to the backstop leverage ratio and the risk grids are binding for those more risk free loans -- not binding for those more risky

loans and binding for the most risk remote loans. So we think that there's adjustments of the 2% backstop leverage ratio, again, strikes the appropriate balance between equity and CRT capital.

Finally, I'd like to comment on the participation of reinsurers in the GSE CRT market. They provide a significant volume of institutional based equity capital.

For example, the equity capital base of the global reinsurance market is estimated to be in excess of $600 billion. Importantly, reinsurers are not subject to the volatile margin calls and other disruptive forces that most times have little to do with underlying credit fundamentals.

For example, we can look at experience in the first and second quarter of this year, as well as experience in the first quarter of 2016, to see how for capital market participants, the buyers of capital debt markets, stacker bonds, and CAS bonds, credit spreads widened out meaningfully for those transactions. But they remained relatively stable as provided by reinsurers.

Further, reinsurers represent a diversified multiline CRT counterparty with more stable pricing across the market cycle, and especially during times of economic stress.

Finally, reinsurers are relatively new to the mortgage credit risk market. They're still learning how to underwrite this class of business, which is important in diversifying for their balance sheets. As they continue to gain experience through a steady supply of CRT transactions by the GSEs, they will represent an increasingly stable supply of capital. But it's critical that that CRT issuance by the enterprises continue at its current pace, and in fact, allocate even more to the reinsures given the stability of their capital base.

We wish to once again, thank the FHFA again for the opportunity to comment. The Portum Trust team, with its vast market experience, advanced analytics, and loan level data, remain available as a resource to the FHFA. Thank you.

Moderator: Next speaker is Kelly Haughton, Global Index Group. Please go ahead.

Kelly Haughton: Good morning. This is Kelly Haughton from Global Index Group. We are in the business of, we have designed a privately issued risk transfer mechanism, we call duETS. And as a result of that activity, we have studied the bank Capital Rules with regards to things like CRT, and

duETS in depth. And as I work my way through the agenda for this, can we go to the next page please?

One of the focus that I want to do here is to talk about our experience with working about -- working with banking regulation and risk transfer mechanisms. And then that will move into the situation where we have fully collateralized, no counterparty risk securities. And that they're different from credit default swaps, which is what people were worried about. Can we move on to the next page please? Thank you.

The folks at the Basel organization, as well as the banking regulators here in the United States had post the global financial crisis, they were trying -- one of the things that they were trying especially to fix was the counterparty risk problem.

And that meant the GSEs did not participate in this, but they were credit default swaps that were in the private market and these failed miserably as a way to hedge risk. And the banking regulators wanted to make sure we didn't engage in that because of the level of counterparty risk.

As a result of that focus, the banking regulators did not contemplate fully collateralized, no counterparty risk securities like CRTs. So what happened though, in a parallel basis, was the, outside of the banking framework, the FHFA and the GSEs worked to develop CRTs as a way to manage the risk of the GSEs businesses.

This was a very positive development in that CRTs were developed in a way to make sure that the problems that happened during the global financial crisis would not affect the CRT implementations. And that allowed the GSE some more effectively manage the mortgage risk, mortgage credit risk in their businesses.

Also outside the banking framework, the private sector, i.e. us, have been working on developing fully collateralized, no counterparty risk securities to help manage the risk of mortgage portfolios in general. Both banks and potentially GSEs. Next page.

One of the -- let me describe what a fully collateralized, no risk counterparty risk security is. It's fully backed by US Treasury; it’s held in trust for the sole benefit of security holders. There’s a pot of treasury’s there.

It ends up being a risk transfer mechanism, which reduces the risk of the hedger. In this case, we're talking about the GSEs. It will reduce the systemic risk of the mortgage industry by dispersing housing market and credit risk to long term investors, which was been discussed by previous speakers in depth. I think is a -- this is very important in terms of the safety and stability and the safety and soundness of the housing finance industry.

And so what we've ended up with is we need a process, I'm missing a line down at the bottom. For innovation and risk management to benefit housing finance in GSEs, we must have capital rules that give them proper credit for using these risk management tools. Next slide please. Oh boy, this got messed up. Okay.

There's three columns of answers to the questions. One is, the first one is for credit default swaps, the second one is for credit risk transfer, and the last one is for fully collateralized, no counterparty risk securities.

Each one of these -- one of the concerns that both the banking regulators and the GSEs have, is that you don't want securities like credit default swaps to be used. And that credit default swaps were used by banks and other financial institutions during the buildup of the bubble in 2005, '06, '07. And this didn't work because of the counterparty risk.

And there's so if you're trying to prevent from something like the credit default swap debacle to infect the GSEs, the CRT markets and the more generally fully collateralized no counterparty risk securities, are doing that by the structure of the products.

This is important that we make the distinction between the things that blew up during the general financial crisis and the -- what the instruments we're talking about today. Next slide, please. Thank you.

Because of the nature of these fully collateralized no counterparty risk CRTs, they're basically capital assets set aside in trust to cover the potential losses. They are in effect loss reserve accounts. The money is set aside in trust.

Requiring additional capital to be set aside in case the US Treasury goes broke, is redundant and inappropriate. Having in place a prudential risk floor for CRTs means less use of risk reduction techniques and reduces the safety and soundness of the GSEs. We recommend an elimination of the prudential risk floor for CRTs. Next slide.

In fact, we believe that rather than discouraging risk management, the FHFA and the Capital Rules should be encouraging prudent risk management by the GSEs. Not only should you improve the Rules for CRTs by eliminating the prudential risk floor, but you should also provide rules for the use of other fully collateralized no counterparty risk securities as risk transfer mechanisms. The GSEs --

Moderator: You have two minutes.

Kelly Haughton: The GSE's need more tools to manage risks, not fewer. The same is true, of the private sector as well. And anyway, next page.

So in conclusion, our recommendations to improve safety and soundness is, improve the Rules for risk management tools that can reduce the risk of the GSEs, risk management tools can reduce systemic risk. We think you should eliminate the prudential risk floor for CRTs. And implement rules for other types of securities, like CRTs as discussed in our written comment. Next page.

There is my contact information. If anyone at the FHFA or anyone else would like to discuss this presentation, I'd be happy to talk to you. Thank you very much for having this listening session. We appreciate being asked our opinion. And we look forward to having the FHFA have further contact with all of us speakers. Thank you.

Moderator: That concludes our conference. Thank you for using AT&T Event Conferencing Enhanced. You may now disconnect.