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The Honorable Mel Watt
Director
Federal Housing Finance Agency
400 7th St. S.W.
Washington, DC 20024

RE: Fannie Mae's and Freddie Mac's Duty to Serve Underserved Markets Plans

Dear Director Watt:

Arch Capital Group Ltd. ("ACGL") is pleased to provide comments regarding Fannie Mae's and Freddie Mac's (together, the "Enterprises" or "GSEs") proposed Duty-to-Serve Underserved Markets Plans (the "Plans").

First, we commend the Federal Housing Finance Agency (FHFA) and the Enterprises for their substantial progress establishing and implementing the Duty-to-Serve requirements. In addition to the Proposed Evaluation Guidance recently published, finalizing and implementing the Enterprises' Plans will ensure a robust secondary market for mortgages made to low- and moderate-income families for manufactured housing, affordable housing and rural housing – policy goals which ACGL shares.

Second, we would propose that the Duty-to-Serve issue can only be addressed by also considering the role of the Federal Housing Administration (FHA) programs. The Duty-to-Serve requirements for the Enterprises, or their successors, should not compete with each other or the FHA. Instead, these programs should work in tandem as part of a comprehensive plan to enhance housing affordability and access.

ACGL is a leading international insurance organization, and it services commercial, institutional and individual customers through its mortgage, property-casualty and reinsurance offerings. As the leading provider of private mortgage insurance in the United States,[1] and an active participant and innovator in the Enterprises' Credit Risk Transfer programs, ACGL is dedicated to making substantial, lasting equity investments in the U.S. housing market by bringing high-quality private capital to the housing finance system and contributing to overall economic growth. ACGL is committed to expanding opportunities for first-time homebuyers, including low- and moderate-income families, many of whom use mortgage insurance to qualify for the purchase of their home. ACGL is well positioned to provide input on the Plans, and specifically the need to improve transparency in the Enterprises' pricing, and any associated

[1] AGCL provides mortgage insurance in the United States through Arch Mortgage Insurance Company, Arch Mortgage Guaranty Company, United Guaranty Residential Insurance Company and United Guaranty Mortgage Indemnity Company (together, "Arch MI").

subsidization of risk, to ensure the Plans are executed in a safe and sound manner that protects the GSEs, borrowers, taxpayers and the economy as a whole.

Comments

Overall, ACGL is supportive of the Enterprises' Plans and their objectives. However, ACGL maintains that the Plans need to ensure the GSEs continuously evaluate and price the risk of loss to ensure that the loans do not present an unacceptable risk to families and taxpayers. In addition, the GSEs should report on the cost of the credit and collateral risk associated with each program, as well as any subsidization necessary to maintain affordability. This added transparency will enable the FHFA to confirm the Enterprises' Plans serve their intended purpose without imposing excessive risks on borrowers, taxpayers or the economy as a whole, and ensure they are sustainable throughout economic cycles. Added transparency is also essential to arm Congress and policymakers with the information they need to evaluate the Duty-to-Serve obligations and the associated funding under various housing finance reform proposals. Following are our recommendations for ensuring a prudent, transparent approach to managing this risk, while supporting access to affordable and sustainable mortgages for all income levels and market segments.

I. Define Acceptable Risk of Loss

First, and most importantly, the FHFA should require the Enterprises to continuously evaluate each loan program in their Plans to ensure that the underlying loans are sustainable and do not present an unacceptable risk of foreclosure. The negative effects of a foreclosure on all parties cannot be overstated. Families are uprooted; children often have to change schools; homebuyers lose their homes; their credit is tarnished; and hard-earned savings for a down payment – often the primary source of wealth for a working family – are destroyed, jeopardizing the family's financial security and retirement. As a matter of sound housing policy, the Enterprises need to consider what level of foreclosures constitutes an unreasonable risk of loss.

Industry participants, including servicers, investors and mortgage insurers, also experience losses as a result of foreclosures. And the severity of losses associated with affordable housing programs can be exacerbated when, for example, the borrower has very little equity in the property, when the value of the collateral has decreased or when there are not purchasers readily available to buy Real Estate Owned (REO) properties. Declining home values may also limit opportunities to refinance into loan products that are more affordable, increasing the frequency of foreclosure. The recent financial crisis demonstrated that the risks of foreclosure can also accumulate in geographically concentrated ways that have a deleterious effect on entire neighborhoods and communities, and can even accumulate nationally, jeopardizing the financial system and broader economy.

Mortgage insurance (MI) companies participate in the Enterprises' affordable housing programs primarily by insuring loans with very low down payments, (e.g., 3% down or 97% loan-to-value [LTV]), and insuring manufactured housing secured by real property.[2] In addition, the Enterprises purchase, and MI companies insure, low down payment loans in which the borrower receives a 1–3% equity grant.

[2] Mortgage insurers are restricted to insuring against financial loss under the terms of a note secured by a mortgage, deed of trust or other instrument that constitutes a lien on real property, provided the improvement on such real estate is a residential building designed for occupancy by not more than four families. See NAIC Mortgage Guaranty Insurance Act 630 s 1-17, which has been incorporated in whole or in part in many states.

As the leading provider of mortgage insurance in the United States, Arch MI has been insuring loans for over fifty years and has extensive data on the performance of loans secured by manufactured housing as well as 97% LTV loans. With respect to manufactured housing, Arch MI's data shows that loans secured by manufactured housing during policy years 1995–2007 were 2.9 times more likely to result in foreclosure than loans secured by a single-family residence, all else being equal. Manufactured homes depreciate more quickly than site-built homes and the diminishing property values often hinder the ability of homeowners to sell their properties without suffering a loss, thereby substantially increasing the risk of foreclosure.

Similarly, very low down payment loans experience a higher rate of foreclosure compared to loans in which the borrower has greater equity in the property as a result of a larger down payment. Arch MI's data shows that loans with 97% LTVs originated during policy years 1995–2007 are 1.7 times more likely to result in a foreclosure than loans with LTVs below 97%. The frequency of foreclosure on 97% LTV loans is higher due to the borrower's limited equity position. However, this increased frequency is likely tempered by the fact that the home is often appreciating in value, which increases the ability of the borrower to sell the property in strengthening markets without suffering a loss. Without the benefit of house price appreciation, the 1.7 times increase would likely be higher. Combining risk factors, such as manufactured housing and low FICO scores, with very low down payment loans only compounds the risk and may result in an unacceptable loss to both families and market participants.

Finally, in addition to the increased occurrence of foreclosure associated with manufactured housing, the magnitude or severity of losses that result from the foreclosure event are higher as a result of the depreciating value of these assets. The costs associated with servicing loans in default are also higher, particularly in recent years, as a result of increased regulatory requirements. Arch MI's data shows that during policy years 1995–2007, the average loss for loans secured by manufactured housing was 6% higher than that of single-family residences. This increased frequency and severity of loss to servicers, insurers and investors should be considered in evaluating the overall impact to the Enterprises' goals.

To mitigate the increased risks associated with the Duty-to-Serve programs, we agree with the Enterprises' measured approach, which is predicated on first analyzing available data and then piloting new programs to measure success prior to broader implementation. The data collected during the pilot programs should be compared against established thresholds that define what constitutes a reasonable risk of loss. Providing affordable, safe housing for underserved markets is an important policy goal, and providing enhanced "access" can only be achieved over the long run with programs and products that are proven to be sustainable and do not present an unreasonable risk of loss to homeowners, the GSEs, or taxpayers.

II. Quantify the Cost of Each Program

FHFA should require the Enterprises to continuously evaluate and report on the cost of the credit and collateral risk associated with each program, as well as any subsidization necessary to carry out program objectives. A fundamental lesson from the crisis is the necessity for a countercyclical approach to risk management that is also mindful of the need to preserve capital and minimize risk to borrowers, taxpayers and the economy as a whole. Transparency into the cost of each Duty-to-Serve program will enable the Enterprises to assess the viability and sustainability of the programs within their capital constraints, as compared to the implicit cross-subsidization that currently occurs.

The increased frequency and severity of losses associated with manufactured housing and very low down payment loans are directly correlated with the increased cost of the credit risk and collateral risk associated with each loan. Assuming the risk of foreclosure is acceptable, the Enterprises may choose to charge the entire cost of the increased risk to borrowers, or they may choose to subsidize the costs in the interest of maintaining affordability or availability of the program.

Consider the example of a family that wants to buy a manufactured house, has a representative credit score of 680 and can only afford a 5% down payment. Based on Fannie Mae's published Loan-Level Price Adjustment[3] (LLPA) matrix dated April 25, 2017, the increased risk associated with credit score/LTV and manufactured housing would require an increased interest rate of 1.250% and 0.500%, respectively. However, under the HomeReady program, Fannie Mae waives this additional 1.750% at delivery for loans with an LTV over 80% and a credit score less than or equal to 680.[4] The Enterprise thus subsidizes borrowers by waiving the LLPA for participants in its HomeReady program (Freddie Mac's Home Possible program provides a similar subsidy in the same scenario); the cost of this subsidization should be quantified and shared across the entire primary residential mortgage market.

In the example above, the credit and collateral risk associated with high LTV and manufactured housing can be material, particularly if these features are accompanied by other risk variables such as low FICO scores. While the costs are high, the Enterprises choose to subsidize the costs to maintain affordability for low- and moderate-income borrowers in accordance with the policy goals set forth by Congress and FHFA. However, the costs of the programs as well as the policy goals change over time; thus, the FHFA should require the Enterprises to explicitly track and report these costs.

III. Transparency is Critical to Successful Housing Finance Reform

FHFA should require the GSEs to regularly report their performance against their Plans, including the cost of the credit and collateral risk associated with each program, and the explicit subsidization offered to borrowers to maintain affordability. This added transparency into the cost of each program will provide policymakers with critical information as they evaluate Duty-to-Serve requirements and associated funding mechanisms in various housing finance reform proposals.

Numerous recent housing finance reform proposals include provisions that will impact the Duty-to-Serve programs. The Urban Institute and the Milken Institute released separate proposals that each included establishing a separate Duty-to-Serve trust funded by a 10 basis point fee on all loans.[5] The Housing Policy Council proposed transferring a fixed percentage of revenue to the Department of Housing and Urban Development for distribution to local housing finance authorities to meet Duty-to-Serve goals.[6] Congress has the ultimate responsibility to define the Duty-to-Serve requirements for the Enterprises or their successor entities. Without robust data on the cost of the programs, Congress will be ill-equipped

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[3] The LLPAs are delivery fees that can either be paid at closing or divided by a number of years and added into the interest rate. The total fee itself is not added to the interest rate.

[4] Fannie Mae's LLPA Matrix still requires LLPAs for Minimum Mortgage Insurance Coverage since mortgage insurance is still required for loans over 80% LTV. Unlike the Enterprises, mortgage insurers have limited ability to cross-subsidize since they are in a first loss position on loans with little or no equity.

[5] Urban Institute suggested a 10 bps fee to fund initiatives in "A More Promising Road to GSE Reform" by Jim Parrott, Lewis Ranieri, Gene Sperling, Mark M. Zandi, and Barry Zigas; Similarly Milken Institute proposed 10 bps fee to fund a housing trust fund in "Housing Finance 2.0" by Michael Bright and Ed DeMarco.

[6] Housing Policy Council suggested transferring a fixed percentage of revenue to HUD for distribution to state and local housing finance authorities in "Mortgage Securities Insurance Companies' (MSICs) and Housing Finance Guaranty Associations" (H.R. 1859).

to hold the Enterprises or successor entities accountable for achieving their given public missions while effectively managing risk across the housing finance system.

Finally, following the model of the Community Reinvestment Act applicable to federally chartered banks, the GSEs should similarly avoid requiring business partners to participate in programs that present an unreasonable risk of loss to other market participants. Private capital participation has been sidelined in recent years due to the high degree of policy uncertainty and instability in the aftermath of the financial crisis. Clarity and transparency, including with respect to the Enterprises' Duty-to-Serve Plans, will be essential to increasing and sustaining private capital participation in the mortgage market. Moreover, the degree of cross-subsidization the GSEs or successor guarantors are expected to support, will directly impact the risks of foreclosure, the amount of private capital needed in the system to protect the taxpayer, and the cost of mortgages to homeowners across the board.

Along the same lines, ACGL also recommends a more coordinated effort by FHFA, the Administration and Congress to more clearly define the separate missions of the FHA and the Enterprises to serve underserved markets so as to eliminate any negative competition or unnecessary overlap between the government programs, which could lead to the accumulation of excess risk in the housing finance system. Controlling excessive risks protects individual borrowers and helps keep credit affordable to the broader market.

Conclusion

ACGL appreciates the opportunity to offer its recommendations on the Enterprises' Plans.

We look forward to working with you and the Enterprises as you finalize the Plans in the coming months. Please do not hesitate to contact me at 441.278.9179 or arippert@archcapgroup.com regarding our recommendations.

Sincerely,

Andrew Rippert
CEO, Global Mortgage Group
Arch Capital Group Ltd.