INVESTORS UNITE

Thank you for the opportunity to provide input on the Federal Housing Finance Administration's intention to implement front-end risk transfer mechanisms. Transferring credit risk from the government-sponsored entities (GSEs) Fannie Mae and Freddie Mac to other financial institutions marks a profound change in U.S. federal housing policy. Its impact on access to affordable housing for millions of Americans, its effect on the legal conservatorships of the GSEs, and the ramifications for taxpayers must be fully considered before increasing the use of risk transfer mechanisms. I am offering these comments on behalf of over 1,400 shareholders in Fannie and Freddie that are members of Investors Unite.

Transferring or sharing risk is a common tool used by large enterprises for financial management. However, in the context of the conservatorships of Fannie and Freddie, front-end risk sharing specifically and all risk-sharing, if not done on appropriate terms in appropriate market conditions, moves further away from the Housing and Economic Recovery Act's fundamental requirement to restore the fiscal soundness of these privately-owned companies. In fact, risk-sharing threatens to accelerate the erosion of the value of these enterprises without regard to the legal rights of their shareholders. The gross misapplication of HERA over the course of the conservatorships, and more particularly the 2012 net worth sweep, remains the subject of litigation.

The stated goals of transferring risk from the GSEs are to decrease potential risks to taxpayers during downturns in the housing market and to bring more private capital into the housing finance system. It is not clear if either objective will be achieved with the risk sharing strategies used to date and contemplated going forward without introducing new uncertainty into the housing market.

First, merely shifting credit risk to other parties, whether in back-end transactions or, as FHFA now contemplates, at the front end, will not make the GSEs less risky. In fact, forcing the GSEs to cede what would likely be the least risky parts of their portfolios to private sector players with unproven financial reliability and without a duty to serve all Americans in the housing market, will introduce serious distortions into the mortgage finance system. As counterparties are (understandably) more willing to take on the risk of higher-quality loans, risk-sharing leaves the GSEs with the riskiest loans. Also, we have not seen new regulatory requirements to enhance the GSEs' capability to withstand downturns like the financial crisis. Without capital and the business necessary to generate and sustain that capital – the very business which is given away in

risk-sharing transactions – the GSEs would not be made safer and more solvent as HERA requires.

In risk sharing transactions the GSEs give up rewards as well as risks, as they retain less of the guaranty fees they charge when they purchase loans to be securitized. The core of the business model of the GSEs is already being chipped away with back-end risk sharing, and the introduction of front-end risk sharing would accelerate this destructive policy. In addition, this is occurring as the GSEs are required to turn over profits to the Treasury Department each month under the net worth sweep. This is a deliberate policy which mandates ever-smaller capital buffers at the GSEs over time. The legal stripping of their assets has all but eliminated the ability of the enterprises to cover normal business losses. Even if the primary objective of risk sharing is to engineer a larger role for private capital in mortgages, systematically undermining two of the largest financial companies in the U.S. creates major uncertainty in the mortgage market and makes it more likely taxpayers will be relied on to maintain the companies' solvency, not less likely.

Second, as to the mortgage market as a whole, private sector parties cannot and will not provide needed countercyclical liquidity on the national scale the way Fannie and Freddie have. A diminished role for the GSEs in this function would create an additional level of uncertainty. FHFA cannot give away profits to other market participants in good times and still expect the same ability of the GSEs to support the mortgage system in bad times.

Third, the issue of capital adequacy of financial counterparties to the GSEs for front-end risk sharing raises the question of whether this is real risk sharing at all. If banks and mortgage insurers originating and selling loans to the GSEs with credit risk retained do not have capital with which to meet their eventual financial obligations when loans go bad, the GSEs – and taxpayers by extension – will be left "holding the bag" covering unreserved-for mortgage credit losses that regulators and stakeholders will have assumed originators would cover. On a macro level, there is simply not enough capital in the private marketplace to cover anywhere close to the roughly $5 trillion in mortgages the GSEs back over the course of complete housing cycles.

The nation's banks have nowhere near the hundreds of billions of dollars in excess capital needed to absorb anything but a small portion of the GSEs' business. Of course banks want to reduce guarantee fees they pay to Fannie and Freddie. But these institutions have not in recent years demonstrated the ability to appropriately measure mortgage credit risk and the amount of capital they need to cover it responsibly. They will have to raise that capital if they don't have it. Leading up to the financial crisis, many large financial institutions issued private mortgage securities. When the market for these securities fell apart, the banks were stuck with unexpected losses, had to raise capital, and faced massive litigation from investors who contended they were lied to about the credit risk of the mortgages underlying these securities. Lending and mortgage credit support from banks has dried up since the financial crisis as they licked their financial and legal wounds and recovered from self-inflicted damage.

Mortgage insurers boast about having nearly $10 billion in capital and predict they will raise much more over time with the passage of front-end risk-sharing but their own financial crisis experience is not encouraging. Unlike property/casualty insurers, which are held to rigorous standards for having the cash to cover even catastrophic losses, mortgage insurers have not been well regulated by supervisors and have relied on their counterparties the GSEs – and FHFA the GSEs' own regulator by extension – to make sure they have capital. The mortgage insurers survived the financial crisis survived only due to massive financial and regulatory forbearance and mercy from the GSEs, and this does not inspire confidence as to their role going forward. Should a severe market downturn occur, it is possible the U.S. government, meaning the U.S. taxpayer, could be asked to provide emergency funding directly to mortgage insurers or indirectly through the GSEs to avert of a broader economic crisis. Certainly, this is not consistent with FHFA's housing policy objectives.

Fourth, there are the distributional concerns that front-end risk sharing is really only an option for the largest too-big-to-fail banks. On the one hand, the Mortgage Bankers Association has long called for the initiation of front-end risk sharing, arguing that transferring risk before the loans are pooled and securitized could enhance transparency for all lenders. However, when FHFA announced its request for comment, MBA President and CEO David Stevens conceded that smaller lenders would probably have to enter into complicated collateralized recourse agreements or work with loan aggregators (read: the larger banks with which they compete) or simply be shut out of front-end risk sharing. The MBA says it wants to pursue ways of preserving the ability of smaller and community-based lenders to continue to be able to deal directly with the GSEs. However, front-end risk sharing that leaves smaller bankers on the sidelines would serve to make large banks even larger and limit choices for potential homebuyers.

Fifth, there is the issue of whether risk-sharing is consistent with FHFA's safety-and-soundness mandate under HERA. If risk sharing is such a good thing as a matter of principle, then why haven't regulators of banks and insurance companies mandated the companies they supervise push credit and other forms of financial risk to other parties as other parties seek to have FHFA force Fannie and Freddie to do? At the end of the day there is a defined amount of financial risk in the system and a limited amount of hands in which it can come to rest. While concentration of financial risk in too small a number of hands may be a valid public policy concern, as no one likes too-big-to-fail institutions with the systemic and counterparty risks they represent, we have the new FSOC regulatory model and SIFI (systemically important financial institution) designation and capital regimes to address that. Simply mandating that "risk should be pushed away" – especially by too-big-to-fail financial institutions into the hands of other too-big-to-fail financial institutions – as an alternative that may satisfy unrelated political objectives is not really a valid solution to the problem.

Before abandoning real private capital requirements for the GSEs as FHFA has done and turning to massive risk sharing as an alternative to reduce risks to taxpayers, FHFA should be able to

demonstrate empirically that risk sharing transactions under way since 2013 have compelling business rationales absent the mandate created in 2012 with the Conservatorship Scorecard. Would these privately-held companies, operating profitably and outside the conservatorship, pursue risk sharing at all and would they implement risk sharing based on the terms that have been imposed so far? In short, would Fannie and Freddie undertake these transactions simply because they make good business and financial sense, or are they illegitimate divestitures of profitable credit-risk-bearing business forced on them by market rivals through political means?

Finally, transcending these specific policy concerns is the fundamental matter of the rights of shareholders in Fannie and Freddie. Treasury's policy of sweeping the companies' earnings into the general revenue stream is being contested in courts around the country. The government's rationale for this policy has drawn increasing scrutiny, as the "death spiral" narrative presented in court has been shown by discovery to be utterly false. It is possible that the Net Worth Sweep will be found to have violated HERA's requirement to preserve and conserve the assets of Fannie and Freddie and to restore the enterprises to sound and solvent condition. Therefore, it is risky for FHFA to accelerate the erosion of the businesses and capital bases of these enterprises with the ultimate legality of this wind-down-in-conservatorship policy still unsettled.

In conclusion, front-end risk sharing would add to policies underway to hollow out the core of Fannie and Freddie's business and transfer it to private entities that have no track record of backing the credit risk of securitized mortgage loans with adequate capital. This policy has been undertaken at a time when the capital buffers of the GSEs are being systematically depleted. These policy changes could have significant long-term impacts on aspiring home buyers, capital markets and taxpayers. And yet, they have been implemented by administrative action and not legislation. Courts may well determine that the actions of FHFA and the U.S. Treasury Department have violated HERA's obligations to shareholders. Rather than introducing new risk sharing programs that back real mortgage credit risk with illusory promises by undercapitalized counterparties, it would be best to pause, assess the business rationale of these transactions and the impact on market liquidity and stability, and cease from further eroding the rights of Fannie and Freddie shareholders.