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Federal Housing Finance Agency
Office of Financial Analysis and Modeling
400 7th Street, S.W., 9th floor
Washington, D.C., 20219

Re: Single-Family Credit Risk Transfer Request for Input

Ladies and Gentlemen:

Barclays has worked as a partner of Fannie Mae and Freddie Mac as a dealer on STACR, CAS, and FWLS transactions since each program's inception. Across thirty transactions between July 2013 through August 2016, Barclays has helped to place twenty-seven billion dollars of securities. Barclays also provides important secondary support for the programs as a leading market maker and provider of repo financing. From these partnerships, we have developed deep understandings of both the perspective of the GSEs and the perspective of investors of the offerings. We are writing today in support of the continued development and refinement of the GSEs' credit risk transfer objectives for single family residential loans.

Question A1: Are there credit risk transfer principles that FHFA should consider in evaluating front-end credit risk transfer transactions that are not listed in Section II? Similarly, are there significant risks that FHFA and the Enterprises should consider in evaluating credit risk transfers structures that are not included in Section III? Please also provide any comments or views about the principles and risks described in Section II and III.

In the FHFA's characterization of pipeline risk, it acknowledges that "loan defaults generally do not occur during the first year [following loan origination] and, if they do, both the frequency and severity of loss should be minimal, making this risk relatively small" (Federal Housing Finance Agency, 2016). Given this finding, single family residential front-end risk transfer deals may not transfer much more risk than STACR, CAS, and FWLS as there is an approximately six-month lag from origination to a risk transfer under these back-end programs. That six month period is arguably the lowest risk period in the life of the mortgage.

A principle of credit risk transfer is for the transactions to be economically sensible; therefore, it might not be appropriate for the GSEs to pay for risk protection during the first six months. At the very least, the GSEs should consider techniques to measure the incremental cost of transferring credit risk in the first months of a loan's lifetime, and ensure this incremental cost is weighted to reflect the empirically lower risk during this stage in the life of the loan.

While actual defaults are unlikely to occur in the first six months, the market's perception of the risk of default could materially change during the six month pipeline and reducing this risk could be valuable to the agencies; therefore, the FHFA should consider other strategies that could be employed to reduce the pipeline risk associated with existing back-end risk transfer. For example, the market risk that the agencies are exposed to during this six-month period could be hedged by forward selling credit risk transfer bonds and/or hedging via an index if one is developed in the future. Additionally, the current six-month period could be shortened by evolving the current procedures for ratings and diligence to streamline the process.

A particular strength of STACR and CAS is their scalability. An average transaction references nearly \$25 billion in collateral UPB. Still more risk on the GSE portfolios could be transferred by focusing on products excluded from the current programs. These programs could even potentially be expanded to hedge the above 80 LTV risk rather than

relying upon primary mortgage insurance from monoline insurance companies, thereby reducing counterparty exposure, reducing wrong-way risk, reducing operational expense, and improving economic sensibility.

In summary, despite the pipeline risk shortcoming, STACR, CAS, and FWLS seem to be the most appealing credit risk transfer strategies contemplated on the basis of their overall strengths and the shortcomings of the alternatives. It is important that the FHFA consider all of its credit risk transfer principles to holistically assess a risk transfer type.

Question A2: How would proposed front-end credit risk transfer structures meet and balance the principles outlined in Section II and address the risks outlined in Section III?

The bilateral agreements that have been contemplated as front-end collateralized recourse transactions have particular pros and cons worth considering. On the positive side, they facilitate front-end risk transfer and increase the alignment of interest on loans that are in the bilateral agreement. On the negative side, bilateral agreements increase the complexity and operational costs of risk transfer for the agencies as even the largest players' bilateral agreements would be relatively small compared to the current credit risk transfer programs that span all originators. Bilateral agreements also give greater advantage to the larger players as small players cannot practically do front-end risk transfer in an economically viable format independently. Finally, bilateral agreements could result in the GSEs being left with an adversely selected pool as originators will be incentivized to do risk transfer on their best collateral.

Regarding mortgage insurance, the FHFA and GSEs could use the front-end risk transfer structures to diversify the dependence on primary mortgage insurance as the most common form of credit enhancement for loans with LTVs in excess of 80 percent. As monolines, primary mortgage insurance providers have higher costs of capital than other multi-strategy insurance companies, a cost ultimately born by the GSEs. Perhaps more importantly, mortgage insurance providers represent wrong-way risk for the agencies in that their likelihood to default increases significantly when the agencies need the insurance the most. The GSEs could pilot a program in which STACR, CAS, or FWLS were used to transfer credit risk on loans with LTVs in excess of 80 percent that do not have initial credit enhancement.

With regard to the principle of transparency, both Fannie Mae and Freddie Mac have done commendable work towards making their credit risk transfer transactions transparent – particularly CAS, STACR, and FWLS transactions. Comparatively less information is readily publically available for the contemplated front-end transactions. Publishing additional data for these transactions (offering documents, operative documents, marketing materials, etc.) would improve the transparency of the programs and work towards broadening the investor base.

Question A3: In considering proposed front-end credit risk transfer transaction structures, how should FHFA and the Enterprises manage the counterparty risk involved in these transactions?

The FHFA has well articulated the elements of counterparty risk in its Request for Input. It would be best to mitigate the counterparty risk by collateralizing any exposures. Short of that, the GSEs should set up limits by which they cap their exposure to any one counterparty to no more than a pre-set threshold. Although it can be complicated to quantitatively assess the risk of exposure to any given counterparty, risk measurement is a necessary undertaking as this risk should influence the amount of collateralization or exposure cap.

It is particularly important to assess the risk exposure in the case of mortgage insurance (both pool level insurance/reinsurance and loan level insurance). As indicated in Appendix B of the Request for Input, this is the type of risk transfer which seems to have the highest level of reimbursement risk due to a non-performing counterparty.

Question A4: In developing their credit risk transfer programs, the Enterprises have used pilot transactions to evaluate new credit risk transfer transaction structures. As FHFA considers proposed front-end credit risk

transfer structures, one option is for the Enterprises to engage in pilot transactions. If approved by FHFA, what issues or characteristics should be tested in pilot transactions?

Forward selling STACR and CAS bonds could be a viable front-end risk transfer strategy. The bonds would be sold at the time the underlying loans are acquired by the GSEs for delivery upon settlement of the STACR or CAS primary issuance. This would reduce the pipeline risk of the STACR and CAS programs, while leveraging the investor appetite and established infrastructure of the programs.

Alternatively, the FHFA could consider implementing a program to hedge pipeline risk using swaps based on a credit risk transfer index. Although a credit risk transfer index does not currently exist beyond the pilot stages, supporting an index calculated from primary and secondary trading levels of existing STACR and CAS bonds could facilitate swap agreements that offload credit risk at the time loans are acquired by the GSEs. While this may raise concerns of counterparty risk, such risk could be mitigated via collateral posting and daily marking to market. The tenor of such swaps could be limited to approximately six months from the acquisition of the loans after which time the credit risk could be transferred by utilizing a back-end strategy.

If deemed promising, the FHFA and GSEs should remain involved in the establishment of such an index to achieve their objectives for such a program – for example ensuring the index does not incentivize investors to transact in derivatives instead of the underlying risk transfer securities which would circumvent the actual transfer of credit risk from the GSEs.

Question B1: What credit risk transfer strategies work best for small lenders? Why?

As detailed by the FHFA, certain front-end risk transfer structures work better for large originators than small originators, because large originators can originate sufficient loan volume necessary to benefit from economies of scale. Bilateral credit risk transfer agreements with small lenders may simply not be practical due to the costs and complexities. A better fit may be the STACR, CAS, and FWLS programs, in which a given deal contains loans with several different sellers and servicers. There may also be opportunities to construct front-end collateralized recourse transactions with loans from several different sellers and servicers, but there would be operational complexities and expenses which could make back-end risk transfer more appealing.

On the fringe, other factors may make a credit risk transfer structure more appealing to a smaller lender. For example, the FHFA should consider how the timing of cashflows may appeal differently to different lenders. A structure in which a lender is compensated for assuming credit risk through a reduction in up-front guarantee fee may be particularly appealing to a small lender to the extent it leaves capital unconstrained; however, this arrangement may be marginally less appealing to the GSEs as it may result in increased counterparty risk. If a small lender is instead to be compensated for the assumption of credit risk with an ongoing fee, it could be structured in multiple ways including as reduced guarantee. However, these tweaks do not address the more fundamental economies of scale problem.

Question B2: Do other types of front-end credit risk transfer work better for small lenders than collateralized recourse transactions? How so?

System wide credit risk transfer programs such as STACR and CAS allow small originators to ultimately benefit from credit risk transfer on a level playing field. Any program with bilateral agreements will be inefficient given the fixed costs of issuance and GSE monitoring and administration. These programs are better suited for the largest sellers and servicers. Even the contemplated front-end collateralized recourse transactions with loans from several different sellers and servicers would entail operational complexities and expenses which could make back-end risk transfer more appealing.

Question C1: How should FHFA and the Enterprises incorporate information learned through the pricing of credit risk transfer transactions into the practice of setting both the level of and frequency of changes in the Enterprises' guarantee fees?

The basis that exists between the guarantee fees charged by the GSEs and the risk premium charged by the markets when the GSEs enter into risk transfer transactions varies over time. While guarantee fees are substantially fixed (changed by regulators only from time to time), credit risk transfer premiums vary with the pricing of each primary offering and continuously in the secondary market. The FHFA should continue to think about how these two market components could be linked or compared.

Making frequent changes to guarantee fees creates a desirable feedback loop between investors and the GSEs/FHFA to ensure credit risk is being properly priced. It would ensure that the agencies are being properly compensated for the risk being taken and therefore would help ensure they are adequately capitalized without having to rely upon future capital infusions.

Additionally, making constant changes to the guarantee fee may be less disruptive to the market than less frequent but larger changes.

As long as originators have enough warning before changes were implemented (90 days to take into account rate locks) then it would generally not be disruptive to the system. Transparency could be further achieved by implementing rules to define how guarantee fees are set. For example, guarantee fees could be a function of a rolling average of market-based credit risk transfer pricing and could optionally include an overlay for the GSE/FHFA view of risk (although such an add-on would reduce transparency).

On the other hand, a liquidity event could be exacerbated if credit risk transfer market pricing widened due to lack of market liquidity, causing the GSEs to also increase their guarantee fee, resulting in additional costs for consumers at the worst time possible.

The FHFA reasonably stipulates that a credit risk transfer strategy should feature stability through economic and housing cycles; however, an alternative perspective is that increased credit risk transfer premiums could signal increased anticipated losses. Over time, the FHFA should track this correlation to develop more robust data on the relationship and the extent to which increased risk transfer premiums are a leading indicator of coming economic stress.

Question C2: Should FHFA and the Enterprises maintain the policy of taking a longer-term view of setting guarantee fees in an effort to provide greater liquidity and stability in the housing finance market? Would a change in this practice impact market liquidity and borrower access to credit? If so, how?

We acknowledge the reasoning that taking a longer-term view of setting guarantee fees would improve stability of the housing finance market, as mandated by the GSEs' Charter Missions. As noted above, to the extent increased risk transfer premiums are a leading indicator of increased mortgage expected losses, an inability to increase guarantee fees may be financially detrimental to the GSEs. We believe a prudent position would be to develop a more robust understanding of this correlation.

Thank you for the opportunity to respond to your recent Single-Family Credit Risk Transfer Request for Input.

Sincerely,
Barclays

Works Cited

Federal Housing Finance Agency. (2015). *Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions*.

Federal Housing Finance Agency. (2016). *Single-Family Credit Risk Transfer Request for Input*.