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October 11, 2016

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

RE: Single Family Credit Risk Transfer Request for Input

Dear Sir or Madam:

The Independent Community Bankers of America (ICBA) appreciates the opportunity to provide input regarding Single Family Credit Risk Transfers (CRTs) on mortgage loans acquired by Fannie Mae and Freddie Mac (the Enterprises). The Enterprises provide vital access to the secondary market for community banks and help ensure a robust flow of capital for mortgage lending to lenders of all sizes in all markets at all times.

Community banks depend heavily on the Enterprises to enable them to offer competitive long-term, fixed-rate mortgage financing for the bank's customers, without having to sell the loans to a competing financial institution. ICBA is committed to working with the Federal Housing Finance Agency (FHFA) and policy makers to make sure that this vital access is maintained, and that the Enterprises operate in a safe and sound manner that protects taxpayers while fulfilling their mandated mission. As such, ICBA remains concerned that current terms of the Senior Preferred Stock Participating Agreements (PSPA) between the Enterprises and the U.S. Treasury require the Enterprises to sweep any and all profits to the Treasury and to steadily reduce their respective capital buffers to zero by January 2018. This will leave the Enterprises with no capital to absorb operational losses and will likely cause a draw against the PSPAs by one or both Enterprises.

¹ The Independent Community Bankers of America®, the nation's voice for more than 6,000 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services.

With 51,000 locations nationwide, community banks employ 700,000 Americans, hold \$3.9 trillion in assets, \$3.1 trillion in deposits, and \$2.6 trillion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

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While the market impact of such an action may be speculative, it is not unreasonable to assume there would be some disruption in the housing market leading to a reduction in the availability of mortgage credit. Further, community bank access to the secondary market could be seriously impacted, leaving some community banks unable to provide long-term, fixed-rate mortgage loans at competitive rates.

ICBA strongly urges the FHFA to direct the Enterprises to develop and implement a capital restoration plan that will protect the Enterprises, taxpayers and the housing economy from the consequences of a Treasury draw by the Enterprises.

General Comments on CRT

In 2012, FHFA directed the Enterprises to set a strategic goal of developing a program to transfer a portion of the credit risk on the loans acquired by the Enterprises to reduce risk both to the Enterprises and taxpayers. Since 2013, the Enterprises have transferred upwards of 90 percent of the credit risk on eligible loans to private market investors. The majority of these transactions have been “back-end” transactions where the Enterprise creates a pool of recently acquired eligible loans and sells the credit risk on that pool through a variety of security structures. To date most of these transactions have involved very little counterparty risk to the Enterprises, however, the CRT securities are illiquid, and currently have unfavorable tax and capital treatment which further limits their appeal and impacts their liquidity.

The Enterprises have also entered into several limited “front-end” CRT transactions with a few large aggregators which transfers credit risk to a third party prior to the Enterprises acquiring the loans, through a variety of securities, pool insurance, or collateral structures. Due to the scale needed to execute these types of transactions, their appeal and availability is limited to a small number of large institutions. Also, in order for these types of structures to work from a price execution perspective, the Enterprises must reduce their Gfees, or other charges, which can create a pricing advantage for the structuring entities (aggregators) along with a revenue drain for the Enterprises. Depending on the structure of these transactions, counterparty risk can be minimized; however, transactions that depend on recourse or performance of a third party naturally carry higher levels of counterparty risk.

Lately, some in the industry have focused on using deeper levels of private mortgage insurance, or DMI, as form of front-end CRT. Instead of the current standard levels of mortgage insurance coverage (25-35percent) depending on the LTV and loan product, higher levels of coverage (45-49 percent) would be obtained, thereby providing coverage down to a 50 percent or lower LTV on an individual loan. Generally, the borrower would pay the insurance premium similar to the way most mortgage insurance (MI) is currently written today. The appeal of this approach for CRT is that all lenders could participate, it can be replicated on a large scale, and it is relatively affordable. The concern with DMI is that its use puts a considerable amount of credit risk on the mortgage insurers who write the coverage, incurring higher levels of counterparty risk than some of the other structures used. During the Great Recession, several mortgage insurance companies rescinded coverage on certain loans, forcing those losses back on the Enterprises and the industry. Additionally, several MI companies failed, and only paid a portion of their claims. While the MI industry has recovered and recapitalized and the Enterprises have revised and strengthened their capital and eligibility requirements for MI companies, the risk of relying on MI as a major form

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of CRT is that, as monoline companies tied solely to housing, MI companies will experience stress at the same time as the Enterprises which creates additional risk for the Enterprises. Also, in order for DMI to work from a price execution perspective, the Enterprises must reduce their fees, thereby reducing their revenue on those loans which are higher risk. Further, borrowers can drop the MI on their mortgage loan when the loan balance is reduced to 78 percent LTV or the value of the property rises to 80 percent LTV based on a current appraisal. As such, the best performing loans with DMI would likely drop the coverage or refinance, leaving the higher risk loans outstanding. Either way, the Enterprise assumes a greater level of credit risk and counterparty risk without being compensated.

Lender recourse, collateral, cash reserves, and combinations of recourse and collateral all pose either counterparty risk, or require size and scale to be economical for the lender to provide. Most smaller lenders would have difficulty providing any of these in large amounts over long periods of time.

The concept of credit risk transfers, while an effective tool to manage Enterprise credit risk, is just that, a tool, which should not be the only method used. Sound credit risk management that properly assesses credit risk and prices for that risk, backed by strong levels of capital held by the Enterprises, are critical to the long term success of the Enterprises. ICBA strongly urges the FHFA to direct the Enterprises to develop and implement a plan to rebuild their capital buffer as required by 2008 Housing Economic Recovery Act (HERA). A strong capital buffer, coupled with an economically sound CRT program, will better protect the Enterprises, taxpayers and the housing market from credit risk.

FHFA has developed a set of guiding principles or characteristics for credit risk transfer vehicles that are used to evaluate all CRTs. These are:

- Reduce taxpayer risk
- Economically sensible
- Continuity of (the Enterprises') core business
- Repeatable
- Scalable
- Counterparty strength
- Broad investor base
- Stability through economic and housing cycles
- Transparency
- Level playing field

ICBA fully supports these principles and urges the FHFA to place special emphasis on these factors: reduce taxpayer risk, economically sensible, continuity of core business, counterparty strength, and level playing field. ICBA believes that following these principles, combined with a robust capital buffer for the Enterprises, will yield better long term taxpayer protection and market stability.

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Answers to questions in the RFI

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.*

ICBA Response. ICBA has no suggestions for additional principles for evaluating front-end CRTs. ICBA's comments and concerns on front-end transactions and on the Principles of Credit Risk Transfer are covered in proceeding sections of this letter.

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?*

ICBA Response. The nature of front-end transactions presents an additional challenge to the Enterprises and FHFA to maintain a balance between the principles outlined in section II and managing the various risks outlined in section III. In particular, front-end transactions by their nature make it challenging to balance continuity of core business, counterparty strength, transparency and level playing field. As discussed earlier in this letter, collateral, recourse, pool insurance and various securities structures require scale to be attractive from a cost perspective. That eliminates smaller originators such as community banks from participating in those structures. Deeper mortgage insurance does level the playing field as long as it is borrower-paid, but the Enterprises incur a heightened level of counterparty risk, thereby driving the Enterprises to reduce the value of MI for price execution purposes.

Front-end CRTs by their nature tend to drive higher levels of risk to the Enterprises. Structure risk and all the aspects listed under counterparty and related Risks are heightened with front-end CRTs. Also, all front-end transactions require a fee cut by the Enterprises to make them work, which deprives the Enterprise of long term revenue. While the Enterprises incur costs with back-end transactions, the Enterprises have more control over the loans included in those structures which enables them to improve the overall execution for themselves.

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?*

ICBA Response. ICBA strongly recommends that the Enterprises and FHFA both actively monitor all counterparties which the Enterprises engage in front-end CRTs. These entities should be subject to higher minimum capital requirements and regular examinations by the Enterprises and FHFA auditors, with a level of oversight considerably higher than non-front end CRT entities. The level of oversight and supervision by the FHFA of these entities should be tailored to the level of Enterprise credit risk these entities have assumed.

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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?*

ICBA Response. ICBA would encourage the Enterprises and FHFA to include lenders of all sizes in these pilots where practical.

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

ICBA Response. As mentioned earlier in this letter, most of the front-end CRTs are impractical for most small lenders. Small lenders generally do not sell large pools of loans to the Enterprises at any one time but rather deliver small pools of loans, and many deliver loans on a single loan basis. Generally, CRTs that can be delivered on an individual loan basis such as recourse, collateral/cash account or DMI work best for smaller lenders. However, many small lenders such as community banks may not originate loans with high LTVs and would not need to purchase MI. As a result, programs that provide fee cuts for DMI loans could actually make lower risk loans more expensive to sell. Some of the FHLB Mortgage Partnership Finance (MPF) programs require some level of credit enhancement, generally in the form of loan level recourse or pool insurance. While those programs seem to work well generally, the production volume is lower than the Enterprises.

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

ICBA Response. See response to question B1.

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?*

ICBA Response. Incorporation of the pricing of the CRTs into the setting and managing of the Enterprise guarantee fees will depend on the extent which FHFA and the Enterprises depend on CRTs to manage credit risk. If all non-catastrophic credit risk is transferred to third parties on a regular basis, the Enterprises will be completely at the mercy of credit investors, likely resulting in frequent and possibly extreme changes in Gfees based on the market's appetite for credit risk. If CRTs are just one part of a credit risk management framework that includes strong underwriting standards, counterparty risk management, the understanding, modeling and proper pricing of credit risk and the rebuilding of a strong capital buffer to protect the Enterprises against credit and operational losses, one would expect less volatile Gfees.

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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?*

ICBA Response. Given the Enterprises unique role as the underpinning of the mortgage finance market, it is imperative to have a level of consistency and certainty around Gfee pricing. As discussed above, frequent and extreme changes will increase origination costs, make it more difficult to qualify borrowers, and likely result in reduced access to credit. ICBA strongly recommends that FHFA and the Enterprises maintain the longer term view of setting Gfees.

Conclusion

ICBA appreciates the opportunity to provide input and comment on the subject of Enterprise credit risk transfers. As stated above, ICBA believes CRTs are one of several tools the Enterprises can use to manage credit risk. However, ICBA believes that a strong capital buffer, in addition to CRTs and other prudent credit risk management strategies, provides the best protection for the Enterprises, taxpayers and the mortgage market overall. ICBA urges the FHFA to direct the Enterprises to develop and implement a capital restoration plan.

We look forward to working with FHFA and the Enterprises on these initiatives. If you have any questions or wish to discuss the content of this letter further, please contact the undersigned at ron.haynie@icba.org.

Sincerely

Ron Haynie
Senior Vice President- Mortgage Finance Policy
Independent Community Bankers of America

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