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Housing Finance & Regulatory Affairs

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Federal Housing Finance Agency
Office of Financial Analysis and Modeling
400 7th Street, SW
Ninth Floor
Washington, DC 20219

Re: Single Family Credit Risk Transfer Request for Input

Submitted via Electronic Delivery

Dear Director Watt:

On behalf of the National Association of Home Builders (NAHB), I appreciate the opportunity to provide input on the Federal Housing Finance Agency's (FHFA) single family credit risk transfer program. Though Fannie Mae and Freddie Mac (the Enterprises) remain in conservatorship, they are as important to the mortgage market today as ever. As the Enterprises continue to operate under the terms of the Preferred Stock Purchase Agreements, backstopped by the U.S. Department of the Treasury (Treasury), the credit risk transfer transactions are a critical means of decreasing the credit risk the Enterprises face and providing additional protection to taxpayers from future credit losses on the Enterprises' mortgage loans.

NAHB is a Washington, D.C.-based trade association representing more than 700 affiliated state and local associations in all fifty states, the District of Columbia, and Puerto Rico. NAHB's membership includes, among others, those who design, construct, and supply single family homes, build and manage multifamily projects, and remodel existing homes. Our builders are proud to construct over 80 percent of the homes produced each year that provide shelter for this Nation's families.

BACKGROUND

The country is in its eighth year of debating how to reform the housing finance system while maintaining a stable, liquid and efficient secondary mortgage market. While there are many components of reform that have eluded consensus, one issue that has widespread, bipartisan support and receives significant attention is the importance of reducing taxpayer risk in a system in which currently approximately 67 percent of mortgage originations have a federal government guarantee through Fannie Mae, Freddie Mac, the Federal Housing Administration (FHA), the Department of Veterans Administration (VA) or the United States Department of Agriculture's Rural Housing Service.

The mortgage finance industry, policy experts, members of Congress, Treasury and the Obama Administration all have expressed the need to reduce taxpayer exposure

to credit risk in the mortgage market. In 2013, as the absence of legislation to enact comprehensive reform of the housing finance system kept taxpayers exposed to the credit risk inherent in the Enterprises' guarantee business, FHFA took the initiative to require Fannie Mae and Freddie Mac each to transfer credit risk on newly acquired single family mortgages with at least $30 billion of unpaid principal balances. In 2014, the *Scorecard for Fannie Mae, Freddie Mac and Common Securitization Solutions* more specifically directed the Enterprises to reduce taxpayer risk through increasing the role of private capital in the mortgage market using various types of credit risk transfer (CRT) transactions to transfer credit risk on newly acquired single family mortgages with at least $90 billion of unpaid principal balances.

The CRT transactions have proved successful in attracting private capital to the conventional, conforming market. Investors have assumed varying levels of credit risk in exchange for bonds structured to meet their individual risk appetites, return requirements, time horizons and regulatory constraints. Reinsurance companies also have played a significant role in sharing credit risk with Fannie Mae and Freddie Mac.

In addition to increasing the required volume of CRT transactions executed each year, FHFA has requested the Enterprises to introduce other enhancements to expand the program. The *2016 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions* requires Fannie Mae and Freddie Mac to transfer credit risk on at least 90 percent of the unpaid principal balance of newly acquired single family mortgages and expand the loan categories targeted for credit risk transfers. Initial CRTs included only mortgage loans with loan-to-value (LTV) ratios between 60 and 80 percent, i.e. the less risky mortgage loans. In 2014, both Enterprises completed transactions using mortgage loans above 80 percent LTV. For 2016, targeted loan categories include non-HARP, fixed-rate loans with amortization greater than 20 years, and mortgages with LTVs greater than 60 percent. The Enterprises also are directed to explore ways to transfer credit risk on mortgage loan purchases not currently included in the targeted loan categories, develop additional CRT structures, refine CRT structures already offered and propose ways to expand the base of investors interested in participating in CRT transactions.

Back-end Risk Transfer

To date, the CRT structures utilized by the Enterprises predominantly have been debt issuances and insurance transfers. Both types of transactions require the Enterprises to purchase the mortgage loans and hold the credit risk until the debt is sold to investors or an insurance or reinsurance company is paid to assume a portion of the credit risk. As the credit risk is transferred after the Enterprises own the mortgage loans and already have undertaken the risk, the transfer is referred to as *back-end risk transfer.*

Debt Issuance

In a Debt Issuance transaction, the Enterprises issue corporate bonds to investors and investors agree to assume a portion of the credit risk on a pool of mortgages. Credit risk transfers sometimes are referred to as credit risk sharing transactions because the Enterprises do not transfer all of the credit risk for the mortgages included in the deals. In their debt issuance transactions, Fannie Mae's Connecticut Avenue Securities (CAS) and Freddie Mac's Structured Agency Credit Risk (STACR), the amount of credit risk transferred to the investor varies by the individual bond as does the loss position, i.e. first loss, mezzanine loss, and catastrophic loss. First loss and mezzanine loss also are referred to as expected and unexpected loss. Expected credit risk is

"credit loss projected to occur if housing market conditions proceed according to a stable long-term trend," and unexpected credit risk is "loss to the Enterprise over and above expected losses should there be a stressful, yet plausible, macroeconomic event." Catastrophic credit risk would produce losses "beyond unexpected loss and would be deemed highly unlikely to ever occur."[1] Early versions of CRT products were designed to transfer large portions of unexpected loss. As the products and markets have evolved, portions of expected and catastrophic losses are now also being transferred in some transactions. Nonetheless, catastrophic risk events are deemed so unlikely, meaning they present so little risk, that the Enterprises have found it too costly (not economical) to transfer much of this risk to the private sector.[2]

The Enterprises receive payment for the bonds at the time of sale; repayment to the investor is tied to the performance of a reference pool of mortgages; investors receive a higher return if the mortgages perform well and a lower return if the mortgages perform poorly. Investors ultimately receive a return of their principal less any covered credit losses.

While investors have a level of counterparty risk in these transactions since they are dependent on the Enterprises to meet the obligations related to the debt issuance, the Enterprises do not incur counterparty risk on debt issuances. The funds received from the investors at the time of the sale of the bond are used to offset any losses.

Credit-Linked Notes

Credit-linked Notes (CLNs) are structured similarly to the debt issuances, but the notes are issued by a trust rather than Fannie Mae or Freddie Mac. This allows the trust to hold the proceeds from the sales of the notes and the Enterprises, through the trust, pay the investors a premium for credit protection on the pool. When there are losses in the pool, the trust compensates the Enterprise based on either a calculated loss schedule or actual losses.

The CLN structure presents less counterparty risk for investors than the Enterprises' debt issuances because the proceeds from the sale of the notes are fully collateralized by the funds held in the trust. The Enterprises do not incur counterparty risk on CLNs.

Insurance Transfers

Insurance Transfers allow the Enterprises to transfer their credit risk on pools of mortgage loans they own to insurance or reinsurance companies. Credit risk transfer pool level insurance is paid for by the Enterprise and the purchased policy is structured so the insurance or reinsurance company takes on a specified aggregated loss amount. For example, a policy might insure all pool losses in excess of 100 basis points of the initial principal balance of the pool, with an aggregated loss amount equal to 300 basis points applied to the initial principal balance of the pool. These transactions are called Credit Insurance Risk Transfers (CIRT) at Fannie Mae and Agency Credit Insurance Structures (ACIS) at Freddie Mac.

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[1] FHFA's Administrative Reform of Fannie Mae, Freddie Mac, and the Housing Finance System

[2] Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions

These CRT transactions pose very little counterparty risk to the Enterprises. Counterparty risk is mitigated due to the requirement that the insurer or reinsurer must post a percentage of the policy liability limit in a trust account from which the Enterprises can draw if the insurer/reinsurer fails to pay a claim. Also, the insurance and reinsurance companies participating in these transactions generally insure risks for many different types of businesses and are not limited to insuring mortgage credit risk. This diversified risk mitigates the vulnerability of these counterparties to a downturn in the mortgage industry that would impact the performance of the mortgage loan collateral.

To–date, the Enterprises have required collateral of 10 to 50 percent of the policy limit to be held in these transactions to mitigate reimbursement risk from the insurer counterparty.

<u>Front-end Risk Transfer</u>

As the Enterprises consider how to expand their CRT program, the options include transactions classified as *front-end risk transfer*. In front-end risk transfer transactions, a specific portion of the credit risk is transferred to a counterparty before the Enterprises purchase the mortgage loans and incur any credit risk. These transactions include deeper mortgage insurance and collateralized lender recourse transactions. To-date, the Enterprises have done 12 front-end risk transfer transactions, all of which have been fully collateralized lender recourse transactions.

Collateralized or Lender Recourse Transactions

In a lender recourse transaction, lenders agree to reimburse the Enterprises for a certain percentage of credit losses on loans sold to the Enterprises in exchange for a fee or a reduction in the guarantee fee on the loans. The lender or a Special Purpose Vehicle holds up to 100 percent of the maximum recourse amount – typically ranging from a first loss position equal to one percent of the initial balance of the covered pool up to four or more percent of the initial balance of the covered pool – in a collateral account. Lenders and consumers have the opportunity to benefit from reduced guarantee fees.

This CRT option poses no counterparty risk to the Enterprises because the maximum potential losses are held in the collateral account.

Deep Coverage Mortgage Insurance

The Enterprises' federal charters require the companies to share credit risk on purchased loans with LTVs above 80 percent. Traditionally, mortgage insurance companies have shared this credit risk with the Enterprises, agreeing to take credit losses up to a specified percent of the Enterprises' credit risk exposure, i.e. the mortgage loan amount, if a loan goes to foreclosure. Combined, the mortgage insurance credit enhancement and the home buyer's downpayment, determine the Enterprises' exposure to credit losses. Typically, mortgage insurance (MI) is purchased at a level that reduces the Enterprises' credit loss exposure to a level between 74.8 percent and 63.1 percent of the property value, based on the property's value at the time the loan is originated, depending on the mortgage insurance coverage.

Deep coverage MI would allow mortgage insurance companies to reduce the Enterprises' exposure to credit losses to as low as 50 percent of the mortgage loan amount. The Enterprises would reduce their guarantee fees on the mortgage loans commensurate with the cost of the risk they transfer to the mortgage insurers. The reduced guarantee fee charged by the

Enterprises in exchange for incurring less credit risk can be passed on to consumers, reducing the cost of the mortgage loans and increasing the availability of credit. Lenders may benefit by offering more competitive pricing to consumers.

Sharing risk with the mortgage insurers introduces counterparty risk. However, recent measures put in place by FHFA, Fannie Mae and Freddie Mac requiring mortgage insurance companies to meet enhanced capital and risk management standards and revising mortgage insurance master policies to update and clarify the responsibilities of insurers, originators and servicers, should provide considerable assurance that mortgage insurance companies are willing and financially able counterparties to the Enterprises. Mortgage insurance companies are not required to post collateral specific to their mortgage insurance obligations, offering instead, the financial and operational strength of the organizations as evidence of counterparty reliability.

To date, the Enterprises have not used deep coverage mortgage insurance as a CRT strategy.

NAHB COMMENTS

NAHB believes the CRT transactions being undertaken by Fannie Mae and Freddie Mac are a significant regulatory step toward reform of the mortgage finance industry in the absence of comprehensive housing finance system reform legislation. The success of the Enterprises' CRT program, to-date, demonstrates that private investors are willing to assume mortgage credit risk for a fee. Traditional investors in the Enterprises' mortgage-backed securities (MBS) did not put their private capital at risk for the credit performance of the mortgage loans, they primarily incurred interest rate risk. Without the significant investment opportunities offered by the private label MBS market prior to the mortgage crisis, private capital, particularly asset managers and hedge funds, has rallied around the CRTs. More than 150 investors have participated in the Enterprises' CAS and STACR transactions with individual transactions commonly attracting between 50-70 investors. The ACIS and CIRT have drawn a new source of private capital willing to taking on a portion of the credit risk associated with Fannie Mae's and Freddie Mac's single family mortgage pools. These risk transfer transactions have attracted global and domestic insurance and reinsurance companies to invest in the credit performance of mortgage pools.

Through the back-end CRT transactions, the Enterprises have transferred a substantial amount of risk to the private market. Combined, debt issuance, insurance/reinsurance transactions, and senior/subordinate[3] transactions, have transferred $30.12 billion of credit risk on $825.27 billion of unpaid principal balance from 2013 through the end of 2015. Front-end lender collateralized recourse transactions have been utilized to transfer $.48 billion of credit risk on $12.68 billion of unpaid principal balance from 2013 through the end of 2015. These levels of CRT are significant, but without fully exploring front-end risk transfer options, NAHB believes FHFA is under-utilizing important sources of private capital that could share risk with the Enterprises and would directly benefit mortgage market participants. In addition, front-end CRT will increase participation by entities that will continue to invest throughout the economic cycle, while it is not

[3] To-date, two senior/subordinate transactions were done by Freddie Mac, both in 2015. These transactions transferred the credit risk on pools of super-conforming mortgage loans not eligible or having limited eligibility for to-be-announced MBS.

clear that investors in back-end CRT will continue to participate in times of market stress.

NAHB believes FHFA should study the potential benefits to consumers and lenders by experimenting with more front-end CRTs in the form of collateralized lender recourse and deep coverage mortgage insurance. Not only do mortgage insurers and lenders offer options for transferring credit risk to additional parties, but developing these front-end risk transfer options may provide the opportunity for consumers and lenders to benefit from lower mortgage costs and increased credit availability.

While both back-end and front-end CRT transactions will benefit the Enterprises and reduce risk to taxpayers, if front-end options include a reduction in guarantee fees, consumers and lenders could realize benefits they would not in back-end transactions.

FHFA has identified a number of key principles it considers critical to ensuring the CRT programs will meet the Agency's statutory and regulatory authority to keep the Enterprises safe and sound, preserve and conserve their assets, and ensure they support liquidity in the housing finance market. In considering broader use of front-end credit risk sharing with mortgage insurance companies and lenders, NAHB believes FHFA should consider how front-end risk sharing differs from back-end risk sharing. Not only are the counterparties and affiliated risks in the front-end and back-end CRTs different, but the approach to sharing risk is very different. NAHB urges FHFA to apply comparable standards to back-end and front-end CRT counterparties and also require both back-end and front-end CRT structures to adhere to the same principles, as applicable, the agency has identified in Section II. While all principles should be considered, not all will be relevant to each type of credit risk transfers.

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?*

NAHB believes FHFA should consider the following additional principles when evaluating front-end CRTs:

- Consumer cost and credit availability should not be impacted negatively.
- The CRT structure should encourage prudent underwriting and align the interests of all parties.
- Benefits should accrue to the stability of the housing finance system and the availability and cost of mortgage credit throughout economic cycles.

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?*

Deep coverage mortgage insurance meets all of the applicable principles outlined in Section II as well as those recommended by NAHB above. Most significantly:

- Deep coverage mortgage insurance reduces the risk of losses to taxpayers by reducing credit losses to the Enterprises in cases of foreclosure beyond those required by their government-sponsored enterprise charters. Taxpayers also are protected from potential losses by the enhanced measures to mitigate counterparty risk. The counterparty strength of MIs has been significantly increased by the Private Mortgage Insurers

Eligibility Requirements (PMIERs) and the revised master insurance policies. Furthermore, the Enterprises could impose additional capital or other counterparty requirements to more fully address the terms specific deep coverage mortgage insurance arrangements.

- Using deep coverage mortgage insurance would not impact the continued operation of the Enterprises' core business. Deep coverage MI simply expands the maximum credit losses a mortgage insurer would incur. Current business processes and procedures do not need to change in order to obtain additional coverage on a mortgage loan.
- Mortgage insurance pricing is transparent.
- Small and large lenders have equal access and benefit equally from deep MI coverage. Lenders will continue to do business with the mortgage insurers as they do today.
- The Enterprises should reduce their guarantee fees commensurate with the cost of the risk they transfer to the mortgage insurers. The reduced guarantee fee charged by the Enterprises in exchange for incurring less credit risk can be passed on to consumers reducing the cost of the mortgages and increasing the availability of credit. Lenders may benefit by offering more competitive pricing to consumers.
- Mortgage insurers have a vested interest in prudently-underwritten loans, aligning their interests with those of the Enterprises.
- Mortgage insurers will price credit risk in all markets since it is their only line of business ensuring a degree of stability in the housing markets throughout the economic cycles.
- FHFA and the Enterprises should put precautions in place to ensure the mortgage insurers do not add credit overlays or apply inappropriate risk-based pricing when providing deep coverage MI.

NAHB believes collateralized lender recourse transactions also meet the applicable principles outlined in Section II as well as those recommended by NAHB above and the Association would support efforts by FHFA and the Enterprises to experiment with these transactions to allow large and small lenders to participate. The small number of transactions to-date may not have provided the data necessary to accurately gauge the full potential of these transaction structures. We appreciate FHFA's discussion in the Request for Input that outlines the concerns that make these structures challenging for small lenders, however, we would encourage additional evaluation based on the positive components.

- Taxpayers and Fannie Mae and Freddie Mac have negligible counterparty risk because these transactions are fully collateralized, dollar for dollar, for the amount of credit risk retained by the lender.
- If the lender is granted a reduced guarantee fee in exchange for sharing a portion of the credit risk, this could allow the lender to be more competitive and may benefit the consumer if the lower guarantee fee is passed down to the consumer.
- Since the lender is sharing risk, there is an incentive to originate a safe and sound mortgage loan. In lender collateralized recourse transactions lenders are investing in the mortgages they make, aligning the interests of lenders and the GSEs. Misaligned interests in the performance of the loans is one of the factors that led to the mortgage market crisis as lenders originated loans for sale and had no vested interest in the ongoing performance of the mortgage.
- Mortgage lenders are committed to the mortgage industry and are likely to have business models that require them to remain in the mortgage market throughout economic downturns.

NAHB understands there may be some concerns with these transactions. To-date, they have been more feasible for larger lenders due to costs of posting collateral, structuring the transactions, and holding the required collateral on retaining recourse. There also may be a reduced incentive for continued participation when the market is in a downturn. However, since none of the CRT transactions have been tested by a market downturn, NAHB believes a program of measurable size should be established and evaluated through a full economic cycle.

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 counterparty strength of MIs has been significantly increased by the Private Mortgage Insurers Eligibility Requirements (PMIERs) and the revised master insurance policies. However, counterparty strength could be enhanced by a requirement that MI companies choosing to provide deeper MI would be required to increase capital reserves against the additional risk; post collateral against a percentage of risk covered; or reinsure a portion of the risk covered.

As currently structured, the Enterprises do not dictate which MI a lender chooses to use on individual loans. To avoid the potential of unacceptable concentration risk to a mortgage insurance company, the Enterprises may want to experiment with ways to define and mitigate the potential of excessive exposure to an individual mortgage insurance company.

As mentioned above, taxpayers and Fannie Mae and Freddie Mac have negligible counterparty risk in collateralized lender recourse transactions because these transactions are fully collateralized, dollar for dollar, for the amount of credit risk retained by the lender.

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?

To date, only a small number of collateralized recourse transactions have been executed. They have been executed with select lenders and the terms have not been transparent. This makes them hard to replicate on a wide-spread basis and consequently, a market has not developed. In order to assess the potential of these transactions, they must be transparent, standardized, and available to lenders of all sizes to encourage a market large enough to be analyzed. NAHB believes FHFA and the Enterprises should consider establishing standards for a pilot program of collateralized recourse transactions that would allow a market to be established and potential value evaluated.

Collateralized lender recourse transactions to-date have required 100 percent collateralization. To provide a more feasible option for small lenders, the Enterprises should explore deals with less than 100 percent collateralization and introduce other counterparty risk protections.

Deep coverage mortgage insurance has not been tested at all to-date. However, NAHB believes FHFA and the Enterprises should develop parameters for a pilot program. Use of deep coverage mortgage insurance offers the benefits of expanding a tool already widely used to protect the Enterprises; it is equally available to lenders of all sizes; and mortgage insurers cannot retreat to another line of business if the mortgage industry experiences a downturn.

They will remain in the marketplace. The potential for reduced consumer costs and increased credit availability should be a primary consideration.

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

Small lenders will benefit most from parity with large lenders. This means large lenders should not receive pricing benefits or have lower collateral or capital requirements to participate in CRTs. Deep coverage MI ensures small and large lenders have equal access and benefit equally from this option. MI pricing to the consumer does not vary by lender. Also, lenders do not need to incorporate expensive new business systems to utilize deep coverage MI. Processes and procedures needed to do business with the mortgage insurers will remain the same.

For lender collateralized recourse transactions, the Enterprises should consider the use of less than 100 percent collateralization.

CONCLUSION

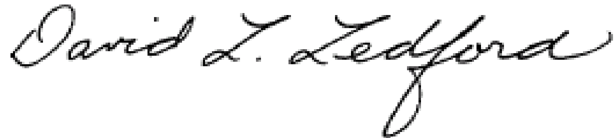
The marketplace should have well-established back-end and front-end CRT structures to ensure the availability and diversity of entities willing to share credit risk with the Enterprises in all economic conditions. The interest of back-end investors in mortgage credit risk is not as aligned with the mortgage markets as those of the entities taking credit risk on the front end. Though none of the CRTs recently issued have been tested in a down market, the traditional capital market players have demonstrated in previous down markets that they will flee from investments in mortgages. The participants engaging in CRTs on the front-end are dedicated to the mortgage industry and their business models, particularly the monoline mortgage insurers, require them to remain engaged and relevant through ups and downs in the economy.

Additionally, both mortgage insurers and lenders have the incentive and the means to try to work out loans rather than incur credit losses.

NAHB believes FHFA should require Fannie Mae and Freddie Mac to establish pilot structures for deep coverage mortgage insurance and collateralized lender recourse CRT transactions that meet the broad principles assigned by FHFA as well as the additional principles recommended by NAHB. Without established programs to generate meaningful volume, the costs and benefits to consumers, lenders, the Enterprises and the housing finance market cannot be accurately assessed. Importantly, for the benefits of the various CTR transactions to be effectively evaluated by all market participants, the Enterprises should provide more transparency on the structure and execution of all deals.

Thank you for your consideration of NAHB's comments on this Request for Input. If you have questions, please contact Becky Froass, Director, Financial Institutions and Capital Markets, at 202-266-8529 or email rfroass@nahb.org.

Sincerely,



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