October 13, 2016

Federal Housing Finance Agency
Office of Policy Analysis and Research
400 7th Street SW, Ninth Floor
Washington, DC 20024
[via electronic submission]

FHFA Single-Family Credit Risk Transfer Request for Input

Dear Sir or Madam:

The Structured Finance Industry Group ("SFIG")[1] appreciates the opportunity to respond to the Federal Housing Finance Agency's ("FHFA") Request for Input (the "RFI") on Fannie Mae and Freddie Mac's (together, the "Enterprises") strategies for Single-Family Credit Risk Transfers. SFIG's views are based on opinions from the members of its GSE Reform Task Force ("Task Force")[2]. The Task Force is comprised of constituencies from all areas of the residential securities market, including investors, issuers, servicers, due diligence firms, law firms, trustees, accounting firms, rating agencies and other market participants.

SFIG's initial observation regarding the "Principles of Credit Risk Transfer" outlined in Section II of the RFI is that the listed principles provide an appropriate framework for a system which is both sustainable and reduces "taxpayer risk" insofar as it is embedded in the Enterprises' the credit guarantee business.

The credit risk transfer program, as it has been carried out so far, has been a great success. The Enterprises have demonstrated the ability to reduce taxpayer risk and bring private capital into the mortgage markets through the capital markets transactions, such as STACR and

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[1] SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, to drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. Members of SFIG represent all sectors of the securitization market, including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. Further information can be found at www.sfindustry.org.

[2] Although the Enterprises are both members of SFIG and of the Task Force, neither participated in the preparation of this response letter.

CAS, and through insurance-based transactions. SFIG believes that "front-end" credit risk transfer has the potential to be superior to "back-end" transfer, since the front-end approach can mitigate the "pipeline risk" identified by the FHFA, aligning the capital markets' pricing of credit risk and the setting of guarantee fees ("G-Fees") and any associated loan level price adjustments ("LLPAs"). However, such front-end risk sharing faces certain obstacles that might offset this advantage.

Although, arguably, the impetus for the Enterprises' recent active use of credit risk transfer programs was the impact of the 2007-2010 financial crisis and the subsequent imposition of the conservatorships in September 2008, SFIG sees no reason why, given its success, credit risk transfer programs should not be a permanent feature of the Enterprises' risk management strategies. It appears to us not to be a "crisis era program" that should be discontinued following the conservatorships.

That said, SFIG continues to strongly believe that reinvigorating the non-guaranteed private label mortgage-backed securities ("PLS") market, an important complement to the Enterprises' credit risk transfer programs, should remain an important priority both for the FHFA and for the broader housing finance industry. Fostering the expansion of PLS and the continued development of credit risk transfer programs in tandem is the best way to ensure that private capital bears the lion's share of mortgage credit risk over time.

We emphasize this point because we are concerned that the very success of the credit risk transfer program may serve to diminish the perception that there is a need for PLS re-invigoration. The history of credit cycles in the housing market suggest that more approaches to risk management are better than fewer, and an active PLS market is a straightforward approach to reducing taxpayer risk. We urge the FHFA not to neglect encouraging the re-invigoration of the PLS market.

As we stated in our September 8, 2014 letter in response to the FHFA's request for input on G-fees, SFIG maintains that the best approaches for the FHFA to take to foster PLS issuance are to decrease the conforming loan limits and to adopt a framework for setting G-fees which reflects the credit risk associated with a mortgage guarantee, considering both the probability of borrower default and any resulting change in payment to investors. Furthermore, such a G-fee framework should be based upon a transparent and disciplined pricing model which takes into account the cost of appropriately capitalizing the Enterprises given their systemic importance - recognizing that incremental increases in transparency should be carefully vetted first to avoid needless market disruption. This approach will allow for any cross subsidization within the Enterprises' books of business to be readily observable. By setting fees appropriately, the Enterprises can continue operating during times of economic duress while insulating the U.S. taxpayers from having to provide extraordinary support.

Ideally a discussion of capitalization should address the "cost of capital"; the "cost of capital" under standard commercial circumstances, would be the blended rate of the Enterprises' cost of equity and of debt at levels sufficient to meet the applicable capital requirements; those costs would, in turn, reflect market-based evaluations by the equity and debt markets, whether

private or public. However, as the FHFA notes in footnote 4 to the RFI, "[w]hile the Enterprises do not hold capital under the Preferred Stock Purchase Agreement, they incorporate capital requirements into their pricing models and business decisions" - including, presumably, the pricing of G-fees.

SFIG observes that, as a consequence of the current situation, issues relating to the Enterprises' cost of capital and capital requirements are deeply intertwined with issues relating to the conservatorships as a whole, including the effects of the Preferred Stock Purchase Agreement arrangement. On balance, SFIG believes that it is more appropriate to comment on those issues in the context of the conservatorships as a whole, and not the much more narrow issues of G-fee and credit risk transfer pricing.

Our response to the specific questions posed in the RFI are set forth below.

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.

Among the principles included in Section II of the RFI is the expectation that the Enterprises assess whether credit risk transfers are "economically sensible". As part of this determination, the RFI discusses analyzing whether any transaction might cost more than "administrative costs, projected credit losses from borrower defaults … and the cost of holding capital to protect against projected credit losses during stressful macroeconomic conditions." SFIG agrees with this approach, but would note again that, during conservatorship, a meaningful determination of the Enterprises' cost of capital may prove elusive. Without this understanding it is challenging for SFIG to offer insight regarding the economic sensibility of any credit risk transfer transaction structure.

Since much if not all of the costs of executing a credit risk transfer transaction are essentially borne by the associated G-fees and any related LLPAs, SFIG advises the FHFA to develop a transparent G-fee pricing model which represents the Enterprises' total cost of capital. Pricing transparency will allow the FHFA to reduce the potential risks of mispricing credit risk in mortgage origination, limiting potentially excessive risk-taking by mortgage originators and the GSE, thereby promoting commercially reasonable and stable pricing through housing cycles. Furthermore, pricing transparency will clarify and quantify the cost and impact of pursuing the Enterprises' housing goals. Lastly, without clear capital rules it is unclear how the FHA or others could ascertain if Enterprises have appropriately determined the cost of "self-insurance".

SFIG also believes that, while the FHFA's support of the employment of a wide array of front-end and back-end credit risk transfer structures by the Enterprises are helping to move them

toward a stable, self-supporting business model, not all structures are equal, and the FHFA should selectively minimize reliance on those structures that significantly increase the Enterprises' non-mortgage credit exposure. The primary considerations here are the avoidance of counterparty risk, basis risk, reimbursement risk, and correlated business risk. While mortgage insurance ("MI") serves an important role in the housing market, over reliance on single corporate entities as credit-taking counterparties exacerbates these risks. Ideally, while credit risk transfer structures that use MI or "deep" MI should be part of the long term mix of options available to the FHFA, SFIG believes that their use should be limited in relation to other capital markets options. And if "deep" MI is pursued, FHFA should consider requiring the MIs or the Enterprises to periodically off-load a portion of the risk into the capital markets.

While the FHFA duly notes that transactions should be repeatable and scalable, we urge that due consideration be given to accessibility. Lowering barriers to entry will minimize operational and credit concentration risks and support market stability through all cycles.

Lastly, SFIG would encourage the FHFA to explore collateralized credit risk transfer structures which transfer some degree of catastrophic risk in addition to non-catastrophic risk. A number of large institutional investors have expressed interest in participating in such transactions. Doing so would provide two significant benefits: increasing the potential pool of credit risk transfer investors and deepening an understanding of the market pricing of catastrophic risk. To the extent these transactions are not fully collateralized, they should be limited as a percent of an institutions capital to insure that the obligations can be met in a catastrophic environment, with the added benefit of mitigating the Enterprises' model risk.

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?

An important priority for any front-end credit risk transfer transaction is attaining immediate risk transference – the transfer of risk at the same time the exposure attaches. The development of credit risk sharing transactions which attain immediate risk transfer is preferable to the back-end approaches because it balances several goals outlined by FHFA in Sections II and III in the RFI such as serving to minimize the Enterprises' basis, market and pipeline risk. Simultaneously, this approach more effectively manages the model risk involved in other credit risk transfer transactions.

Front-end credit risk transfer provides the significant benefit of immediate market feedback, which can be used to help originators and the Enterprises more effectively price the credit risk of new originations. Unlike the back-end approaches, front-end credit risk transfer can align the timing of both the source of funds (the associated G-fee and LLPAs) with the use of funds (the cost of the credit risk transfer transaction).

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?

SFIG believes that among possible credit risk transfer transaction structures, the use of "deep MI" poses some of the greatest counterparty risk. There are several core considerations which lead SFIG to take this position. An initial concern is the existence of the "correlated business risk" discussed in Section III of the RFI. Much like the Enterprises, mortgage insurers' financial performance reflects the strengths and weaknesses of the mortgage market. In the event of a downturn in the mortgage market and a rise in defaults, mortgage insurers would be under financial pressure at precisely the same time the Enterprises would rely on them to cover credit risk.

The presence of these circumstances in turn relate to another set of risk factors which contribute to the overall counterparty risk presented by mortgage insurers. One is the concern that during a period of economic stress, if insurers have underestimated required payouts, they may face insolvency. Another is that the same sort of financial pressures that threaten mortgage insurer insolvency might compel mortgage insurers to explore repudiation to avoid having to fulfill payments to the Enterprises. As mentioned in Section III (C). of the RFI, these sorts of "Reimbursement risk(s)" are a serious consideration that the FHFA needs to take into account.

Additionally, to the extent the Enterprises' consider the use of "deep MI", the Private Mortgage Insurer Eligibility Requirements should reflect this additional risk and the FHFA should consider requiring the MIs to periodically off-load a portion of the risk into the capital markets.

As the FHFA itself notes throughout the RFI, fully-collateralized credit risk transfer transactions present negligible counterparty risk to the Enterprises; SFIG agrees with the FHFA's conclusions on this point, and therefore encourages fully-collateralized transactions to be used whenever possible. Among the potential varieties of fully-collateralized transactions, SFIG has a strong preference for capital markets transactions, since these transactions provide additional benefits such as more transparent pricing and access to the broadest base of capital market participants (investors).

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?

Although each of the principles outlined in Section II provide a useful starting point for developing new front-end credit risk transfer pilot programs, SFIG believes that it is important that FHFA and the Enterprises focus on the following four core priorities: transparent pricing, repeatability, ease of adoption, and increasing market liquidity.

Pilot programs with transparent pricing models will attract the interest of a broader set of private institutions and help develop a more robust market for credit risk. Additionally, the Enterprises should avoid developing pilot programs which cannot be repeated across different counterparties. Furthermore, ease of adoption is a critical priority for the Enterprises to work with credit risk sharing counterparties of various sizes and business models. If entering into credit risk sharing transactions present significant barriers, smaller institutions will be less inclined to take part and the credit risk transfer market will remain thin.

Likewise, increasing the investor participation should not be overlooked; expanding the investor base can only serve to increase the market liquidity and improve pricing stability. In order to do so the FHFA should evaluate those factors that limit liquidity. As a specific example, Mortgage REITs, logical investors in residential credit risk, can only participate in limited amounts due to the legal form of the STACR and CAS transactions. The Enterprises should consider supporting modest changes to Internal Revenue Service regulations and the Investment Company Act of 1940 that would allow REITs full participation, further expanding market liquidity.

Question B1: What Credit Risk Transfer (CRT) strategies work best for small lenders? Why?

On its face, MI would appear to be the ideal credit risk transfer option for loans originated by small lenders: it is easily implemented, it does not require up-front capital, and does not tie up existing capital in the form of risk retention. MI is currently in use in existing Enterprise programs. Therefore expanding the use of "deep MI" to smaller lenders would not require the approval of new providers or the construction of new system or operational methodologies. The MI companies provide reporting and pricing today, so additional operational burdens would not be borne by smaller lenders. However, as mentioned above, the reliance on MI companies comes with such a significant set of counterparty risks that the FHFA should look beyond simply what is easiest to implement today, to what would be a more robust and sustainable solution in the long run.

The Enterprises already utilize STACR and CAS transactions, which effectively serve as aggregation facilities, for back-end credit risk transfer. The FHFA should support the creation of one or more third-party aggregation facilities (public or private) to serve the same purpose for front-end credit risk transfer transactions. Such facilities would eliminate many of the counterparty risks outlined in Section III (C) while also reducing certain credit-related risks enumerated in Section III (B) such as, pipeline risk and basis risk. Best of all, aggregation facilities would attract capital from the deepest funding pool, the capital markets.

Significant obstacles would need to be overcome in putting such an aggregation facilities into place, as no such programs currently exist. Thus, new reporting and pricing schemes would need to be built, systems for fairly allocating capital costs and benefits would need to be implemented, and someone would need to build the aggregation facilities and likely assume certain liabilities (we believe seller co-ops would be the preferred route for the fair sharing of costs and benefits). However, such facilities, if widely adopted, would allow both small and large lenders

to access front-end credit risk transfer options without shifting any incremental risk to the Enterprises.

Although we believe that the emphasis should be on the development of private aggregation facilities, it is possible that the common securitization platform, currently under development by the FHFA, might someday serve as the operational back-bone of such an aggregation facility, further accelerating the implementation.

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

As previously stated, on its face MI may seem like the best credit risk transfer option for loans originated by smaller lenders. However, the counterparty risk associated with mortgage insurers is a real risk that must be considered and capital markets alternatives, such as front-end aggregation facilities and back-end MI risk transfer trades, should be further explored. SFIG believes that the downside risk of reliance on MI does not fully off-set the potential benefits to the Enterprises and taxpayers, and that the alternative of working with a capital markets focused aggregation facility should therefore be explored, perhaps as a pilot program.

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 given price paid by investors for credit risk transfer transactions is dependent on a multitude of economic and non-economic factors in place at the time such transaction comes to market. It should be expected that market appetite, as expressed through price, should wax and wane but in meeting the key objective of market stability (and certain counter-cyclicality) the Enterprises should seek to avoid reflecting every incremental change in price in the G-fee. At the same time, G-fees, as stated earlier, should reflect the actual costs of operating the Enterprises and must be set at levels that allow for them to be self-sustainable. Acknowledging these competing objectives, we believe that CRT pricing should be only one factor to consider, and that pricing should be smoothed out by averaging the impact of individual transaction pricing over a 6 to 12-month look-back period, absent a significant economic disruption. In this way, sellers can plan for longer term business objectives through more stable pricing while the Enterprises mitigate market risk, to a reasonable degree.

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?**

See the comments in C1 above.

SFIG and the Task Force again thanks the FHFA for the opportunity to respond to the RFI.

Please contact Richard Johns at 202.524.6301 or Richard.Johns@sfindustry.com to address any of the points raised in this letter.

Respectfully Submitted,

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Richard Johns
Executive Director
Structured Finance Industry Group, on behalf of the Task Force

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