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BY ELECTRONIC SUBMISSION

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

Re: Arch Capital Group Ltd. Response to Request for Input – Single-Family Credit Risk Transfer

Ladies and Gentleman,

Arch Capital Group Ltd. ("ACGL") is pleased to respond to the Request for Input ("RFI") from the Federal Housing Finance Agency ("FHFA") on proposals to adopt additional front-end credit risk transfer ("CRT") structures and on other credit risk transfer policy issues related to the CRT activities of Fannie Mae and Freddie Mac (the "Enterprises"). In this letter we provide an overview of our thoughts regarding the potential options for front-end CRT alternatives, followed by responses to the questions included in the RFI.

Through its subsidiary companies ACGL writes insurance, including mortgage insurance and reinsurance, in the United States and on a worldwide basis through operations in the United States, Bermuda, Canada, Europe, Australia and South Africa. Our experienced management team and our strong capital base have enabled us to establish a market leading presence in the global mortgage insurance and reinsurance markets. ACGL is dedicated to providing risk management and risk financing products to the U.S. mortgage insurance sector through Arch Mortgage Insurance Company ("Arch MI") and through our well-capitalized highly rated, diversified foreign and domestic reinsurance segment with $7.6 billion of dedicated, long term capital at June 30, 2016.

On August 15, 2016, ACGL announced that it entered into a definitive agreement to acquire mortgage insurer United Guaranty Corporation ("UGC") from its current owner, American International Group, Inc.[1] The UGC acquisition will give ACGL an even more significant presence in the U.S. mortgage insurance market. Collectively, ACGL is dedicated to making substantial, lasting equity investments in the U.S. housing market by bringing high-quality, private capital to the housing finance system. ACGL is well-equipped and highly motivated to

[1] The UGC transaction is expected to close during the fourth quarter of 2016 or early in the first quarter of 2017, subject to receipt of applicable approvals and the satisfaction of other closing conditions.

provide both back- and front-end CRT options to the Enterprises and FHFA through multiple business channels. Equally important, and in contrast to the traditional mortgage insurance business model that employs a simple buy-and-hold approach to risk and capital management, the combined resources of ACGL and UGC will deploy an on-going, active process of risk syndication through the use of third party reinsurance and capital market transactions.

ACGL believes that no single CRT solution meets all of the principles or addresses all of the risks identified in the RFI. For that reason, we think the optimal solution is for the Enterprises to simultaneously pursue a variety of CRT options, including both back- and front-end structures. While the use of multiple back- and front-end structures is necessary to attract a variety of private capital sources, structures alone will not ensure a deep and liquid market for mortgage risk that can persist through the ups and downs of an economic cycle. A clearly formulated and communicated framework for counter-party risk assessment and transaction pricing that is supplemented with a comprehensive and regularly updated dataset must be available to all capital providers. The combined framework and data will provide a level of transparency that is needed to attract efficient forms of private capital, support a broad competitive primary mortgage market and give credit worthy borrowers access to affordable credit without exposing US taxpayers to the risk of another bailout. There are three pillars to the proposed transparency framework; these are:

(1) Make available to the market a comprehensive loan level dataset that fairly and accurately represents the prepayment and loss experience for all residential mortgage loans that are the subject of CRT transactions. The data must be provided in a standardized format and updated on a frequent and regular basis. Doing so will allow providers of private capital access to information that is sufficient to make their own assessment of risk provided they are willing to make the necessary investments in the appropriate resources.

(2) Link prices paid by the Enterprises for CRT transactions to the guarantee fees and loan level price adjustments ("LLPAs") paid by mortgage lenders. Make information available to the market to demonstrate how the Enterprises view the economics and capital frameworks of each transaction. Linking CRT pricing to guarantee fees and LLPAs will pass through the benefits of reduced CRT pricing to all mortgage lenders, both large and small, and thereby strengthen market competition for mortgage loan to credit worthy borrowers.

(3) Develop and deploy a standardized and comprehensive framework for assessing counterparty risk that can be applied uniformly across all participants for all types of CRT transactions. A counterparty risk assessment framework will facilitate a level playing field via an objective measure for the amount of collateral placed in trust as a backstop against assumed limits of exposure. While all counterparties should be required to post some amount of collateral in trust, the proposed framework can provide an objective measure for the requirements.

As the FHFA noted in the RFI "the program should include different transaction structures to attract a diversified and broad investor base, with the objective of improving pricing, increasing secondary market liquidity, and promoting market stability. This requires carefully structuring a suite of transactions that collectively meet different investors' risk appetites, return requirements, time horizons, and regulatory restraints." Providing greater transparency to permit market participants to assess pricing and risk across multiple transactions and structures is critical to all of these objectives.

We believe that the Enterprises and FHFA should continue engaging in back-end CRT transactions while expanding their focus to front-end transactions including: (1) the use of mortgage insurance with greater coverage percentages than the current mortgage insurance percentages required by the Enterprises on loans with loan to value ("LTV") ratios greater than 80%, as well as on loans with below 80% LTV ratios ("Deep Cover MI"); and (2) reinsurance structures.

With respect to back-end CRT transactions, the Enterprises should continue to transfer risk through transactions such as Fannie Mae's Credit Insurance Risk Transfer ("CIRT") and Freddie Mac's Agency Credit Insurance Structure ("ACIS") credit risk transfer programs. These programs offer the enterprises an attractive source of private capital from multi-line global insurers and reinsurers who have diversified books of business that are not highly correlated to U.S. residential mortgage risk. ACGL has participated in these transactions through its highly-rated, well-capitalized and diversified reinsurers and will continue to participate in them.

On the front end, ACGL believes that the Enterprises should engage in CRT transactions using a combination of Deep Cover MI and reinsurance options offered through well-capitalized global reinsurers. We believe that each of these options has significant merits, and a combination of them will better serve the Enterprises and come closest to meeting the principles and addressing the risks articulated in the RFI through all phases of an economic cycle.

Deep Cover Mortgage Insurance

Currently, the majority of Enterprise risk assumed by private mortgage insurers is transferred through the placement of coverage by lenders prior to selling a loan to one of the Enterprises at standard coverage levels required by the Enterprises, which range from 12% to 35% of the principal balance of the loan.[2] Deep Cover MI would feature higher coverage levels than standard coverage and thus would reduce the Enterprise's loss exposure on a loan down to a lower LTV (e.g., 50% or 40%). ACGL believes that the FHFA and the Enterprises should use Deep Cover MI as a front-end CRT option.

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[2] *See* Fannie Mae Selling Guide (Published 8/30/02) B7-1-02 Mortgage Insurance Coverage Requirements (09/29/2015). https://www.fanniemae.com/content/guide/selling/b7/1/02.html.

Deep Cover MI meets the majority of the principles of credit risk transfer listed in Section II of the RFI. It will transfer a meaningful amount of risk to private investors and it is economically sensible. Because it will leverage existing systems and delivery platforms its use will not interfere with the continuity or efficient operation of the TBA market. As monoline insurers who, by state law, are permitted to write only mortgage insurance, the private mortgage insurance companies will remain in the market through stressful phases of the housing price cycle, including during economic downturns.

Front End Reinsurance Options

Potential front-end reinsurance structures include:

1. The Enterprises executing a transaction through a captive insurance company and reinsuring 100% of the risk to a panel of pre-approved reinsurers. This structure is currently used by the Enterprises for back-end CRT transactions and can be deployed as a front-end transaction equally as well.

2. The Enterprises engaging directly with pre-approved reinsurers through a credit insurance policy. Again, this structure is currently being used by the Enterprises for back-end transactions and will work equally as well for front-end transactions.

3. Through a specialty insurance vehicle, with all the resources and infrastructure of a mortgage insurance company, that reinsures 100% of the risk underwritten to a syndicate of highly rated, diversified multiline reinsurers. This form of execution provides all the benefits of a mortgage insurer and rather than holding the credit risk on balance sheet with a single pool of capital, the risk is distributed to a broad base of private capital through a panel of pre-approved reinsurers. In this regard, ACGL has established a Washington D.C.-based insurance company, Arch MRT, to provide the Enterprises with an alternative structure for transferring mortgage credit risk.

Any of the three structures listed here can provide loan-level coverage of credit risk including deep coverage at the time of loan acquisition by the Enterprise. An added advantage of these options is their cost efficient structure that, ultimately, means lower costs for creditworthy borrowers.

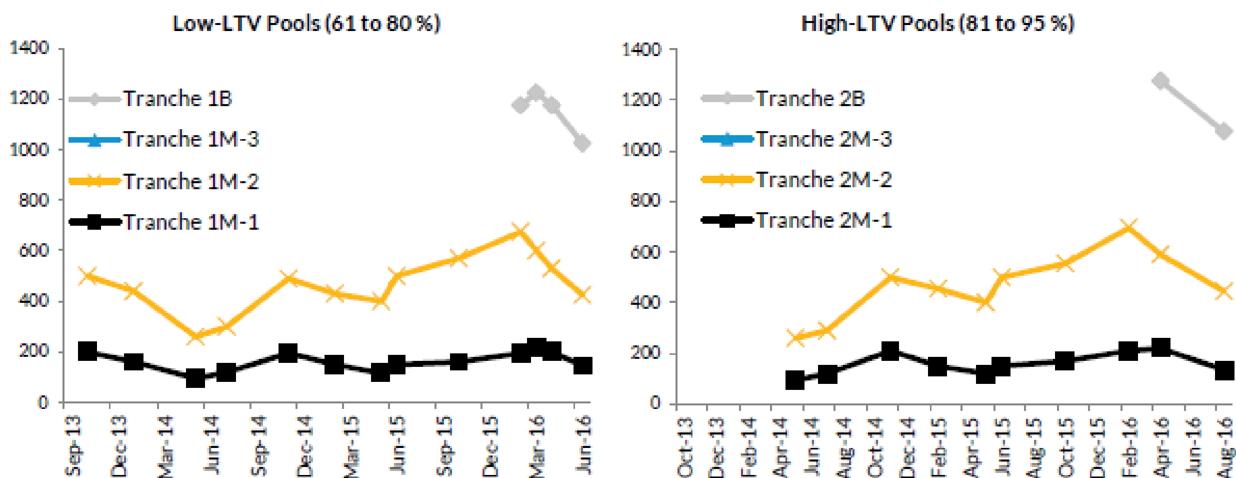
The global reinsurance market has long played an important role in supporting the United States insurance industry and is well positioned to play a significant role in front-end CRT options. The market is comprised of approximately 50 large reinsurers and reinsurance groups, the majority of which are domiciled outside of the U.S. By spreading insurance risks globally, the reinsurance industry enhances both the affordability and availability of insurance, most notably in markets where these risks may be otherwise overly concentrated. Mortgage credit risk is an appealing line of business for reinsurers because its underwriting results are largely

uncorrelated with the underwriting results of their other lines of business and thereby further diversifies their portfolios.

The global reinsurance market represents a deep, high-quality pool of private capital that remains largely untapped by the U.S. mortgage market. Reinsurers have a track record of staying in a market though the business cycle, as opposed to the more volatile capital markets. They have substantial resources (Aon Benfield estimates total global reinsurer capital was $565 billion in mid-year 2015).[3] Thus, increased reliance on the reinsurers' business model simultaneously address the most-often cited concerns with current risk transfer executions – ensuring a source of resilient, diversified capital maintained throughout the credit cycle – while expanding the credit enhancement options available to the Enterprises and improving the housing finance system.

We believe there is empirical evidence that reinsurers view CRT opportunities from a long term, strategic perspective and this translates to more stable pricing of CRTs relative to capital markets execution, such as STACR/CAS. The charts below indicate that pricing widened out in early 2016 with the increase in financial market volatility in the STACR/CAS transactions. We cannot show pricing on the ACIS/ CIRT transactions that we have been involved in since they are not public, but we believe the pricing volatility is substantially lower.

Fannie Mae CAS Spreads at-issuance (basis points over 1-month LIBOR)



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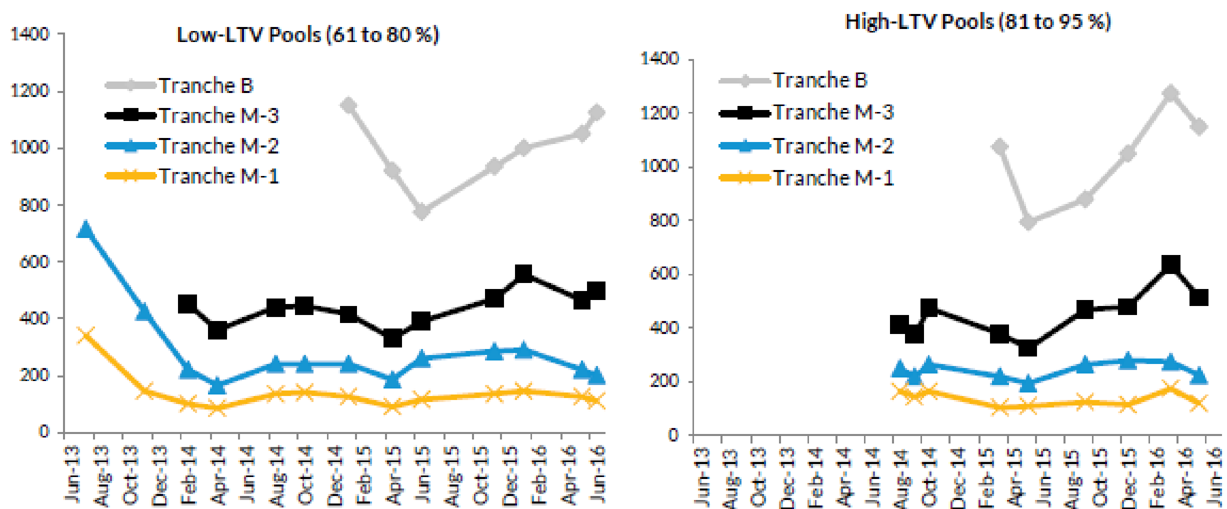
[3] Aon Benfield, Reinsurance Market Outlook (January 2016).
http://thoughtleadership.aonbenfield.com/Documents/20160101-ab-analytics-reinsurance-market-outlook-january-2016.pdf



Source: Urban Institute: Housing Finance at a Glance a Monthly Chartbook August-2016.

The remainder of this comment letter responds to several of the specific 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.*

We believe that the credit risk transfer principles and risks listed in Sections II and III of the RFI generally capture many of the key CRT principles and risks. ACGL believes that borrower impact should be added as a principal.

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?*

ACGL believes that the combination of Deep Cover MI and front-end reinsurance transactions in conjunction with increased transparency by the Enterprises and FHFA permitting meaningful comparisons across transactions is the optimal solution to meet and balance the principles outlined in Section II and the risks outlined in Section III of the RFI. For example, the perceived correlation and counterparty risk associated with Deep Cover MI through private mortgage insurers can be offset by also engaging in transactions with global reinsurers, which avoids the kind of correlation risk described in the RFI and brings to the table diversified, well-capitalized global reinsurers who have the ability to fully or partially collateralize the risk they assume.

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 and Enterprises should manage the counterparty risk involved in front-end CRT structures by spreading the risk between the various alternative structures ACGL has described above. With respect to Deep Cover MI through mortgage insurers approved by the Enterprises, the counterparty risk is reduced through the PMIER capital standards, the new master policies with enhanced contractual protections, and reserving requirements under state mortgage guaranty insurance laws and regulations. With respect to reinsurance options, the counterparty risk can be managed by selecting highly-rated well-capitalized global reinsurers with some or all of the risk being collateralized. And again, across all transactions, greater transparency will permit all stakeholders to evaluate credit and counterparty risk, and to develop accurate and sustainable pricing.

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?*

ACGL believes that using pilot transactions is an appropriate way for the Enterprises to work with private mortgage insurers, reinsurers and other market participants to test, develop and price new CRT transactions and methodologies.

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

ACGL believes that both Deep Cover MI selected by lenders and reinsurance options selected by the Enterprises will work for smaller lenders. Small lenders have systems and processes in place to order private mortgage insurance at loan origination. Moreover, full transparency will permit smaller lenders to accurately assess transactions and to understand how guarantee fees are affected by particular transactions.

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

As noted in the RFI, collateralized recourse transactions can be prohibitively expensive for small lenders. Challenges for small lenders include bank capital requirements, the cost of posting collateral and the costs of structuring collateralized recourse transactions, including the establishment of a special purpose vehicle. For those reasons, we believe that Deep Cover MI and the reinsurance structures included in our response to the RFI, are lower cost and more efficient sources of CRT that can be made available for small lenders with relative ease utilizing existing delivery infrastructures.

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?*

ACGL believes that the FHFA and the Enterprises should take into account the pricing of CRT transactions in the setting of guarantee fees. In particular, in connection with front-end CRT transactions, guarantee fees should be reduced (increased) commensurately with the reduction (increase) in risk to the Enterprises. The Enterprises and FHFA should also be fully transparent in the analysis and methodology used in the setting of guarantee fees and loan level price adjustments.

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?*

ACGL believes that the FHFA and the Enterprises should take a longer-term view of setting guarantee fees. In our view, market liquidity and borrower access to credit would be best fostered not by the timing of the setting of guarantee fees, but rather by full transparency into the analysis and methodology used in the setting of the fees.

CONCLUSION

ACGL appreciates this opportunity to respond to the RFI. Questions or requests for further information may be directed to my attention.

Very truly yours,

Andrew Rippert
CEO, Global Mortgage Group
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