American Bankers Association
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October 13, 2016

Robert C. Ryan
Acting Deputy Director
Division of Conservatorship
Federal Housing Finance Agency
Office of Financial Analysis and Modeling
400 7th Street, SW, 9th floor
Washington, DC 20219

Dear Mr. Ryan,

The American Bankers Association appreciates this opportunity to provide input on the issues surrounding single-family credit risk transfers by the government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. Below you will find our input and views on the potential development of front-end credit risk transfers (CRT), as requested by Federal Housing Finance Agency (FHFA) in June of this year.

The credit risk transfers required by the FHFA's strategic plan for Fannie Mae and Freddie Mac since 2012 have been one of the most significant reforms to the GSEs' business conduct in recent years. Absent legislative reform, the development and standardization of credit risk transfer programs is likely to be one of the most substantial transformations of the secondary mortgage market to occur since the conservatorship of the GSEs was announced in September of 2008. As FHFA notes in the request for input, the majority of credit risk transfers have, to date, been back-end risk transfers, occurring after the sale of loans by originators to the GSEs. The American Bankers Association believes that the development of back-end credit risk transfers has been a positive development which has reduced taxpayer exposure to potential losses, increased the role of private capital in the secondary mortgage market, and has been undertaken in a fashion which creates no additional burden or cost for borrowers or lenders. FHFA is to be commended for encouraging the development of these programs.

While the focus of this letter is on recommendations and input on the potential development of additional front-end credit risk transfer structures, an important caveat must be that nothing should jeopardize the further development, establishment in the marketplace, or future evolution of the back-end credit risk transfer structures. While it is prudent for FHFA and the GSEs to study alternative credit risk transfer mechanisms and structures, doing so should not undermine or jeopardize the progress that has been made in developing successful back-end structures, including market acceptance and confidence in these structures. Studying other forms of transfer is both appropriate and desirable but must be done in a fashion that does not dilute the nascent market for the successful methods already developed or call into question the commitment of the FHFA or the GSEs to those methods.

PRINCIPLES OF CREDIT RISK TRANSFER

FHFA has identified the following principles of credit risk transfer:

Reduce taxpayer risk; be economically sensible; ensure continuity of core business; be repeatable; be scalable; ensure counterparty strength; have a broad investor base; provide stability through economic and housing cycles; be transparent; ensure a level playing field.

ABA would strongly recommend adding an additional principle: No added complexity or cost for borrowers or loan originators. One of the clear benefits of back-end credit risk transfers is that it has no impact on loan origination, as the credit risk transfer happens after the sale of the loan to the GSEs. Front-end credit risk transfers may not necessarily include such benefits. It is ABA's view that a credit risk transfer structure must ensure that there will be no negative cost or complexity consequences for borrowers or loan originators stemming from the inclusion of a loan in a credit risk transfer structure. The many recent changes to the regulation of the mortgage lending market have already added a great level of compliance and other burden to mortgage originators, with attendant costs and complexities for borrowers. Credit risk transfer should not add further cost or complexity burden, especially when back-end transfer options which do not have proven effective.

Additionally, Credit Risk Transfer should not impose further underwriting overlays or restrictions on borrowers that would result in reduced credit availability.

BACK END CREDIT RISK TRANSFER

As FHFA has noted, both Fannie Mae and Freddie Mac have undertaken successful back end credit risk transfers programs, most notably CAS and STACR. While still in relative infancy, these back-end transfers have shown great promise, with significant risk already transferred to the private sector in keeping with the FHFA goal of 90 percent of the risk on targeted single family 30 year fixed rate loans acquired by the GSEs being transferred. While we support and encourage experimentation and development of a multiplicity of transfer mechanisms, such efforts should be undertaken cautiously, making sure that no actions are taken to undermine or weaken the further development of these successful back-end credit risk transfer mechanisms. Nothing should be done to dissuade or create doubt in the markets about the ongoing commitment of FHFA and the GSEs to these successful transfer mechanisms.

CONCERNS WITH FRONT-END CREDIT RISK TRANSFER

Front-end credit risk transfer mechanism generally fall into one of two categories: Collateralized Recourse, or "Deep MI". While both show some promise, we also have concerns with potential risks and problems presented by both models.

“Deep” MI

Mortgage insurance (MI) has been used as a method of transferring risk for decades. While traditionally implemented as a borrower paid, lender chosen product that reduces the risk to lenders, there are also other forms that have been employed, including lender paid mortgage insurance. MI has generally been used as a tool to expand credit availability by allowing borrowers with lower down payments (and thus higher loan to value (LTV) ratios) to obtain credit and paying a relatively modest premium to offset the risks of their higher LTV. As noted by FHFA, MI is required on loans with LTVs above 80 percent to be eligible for purchase by the GSEs. “Deep” MI contemplates further MI coverage to further reduce the risk on the loans. “Deep” MI can be implemented in any number of ways, some of which may be more promising or problematic than others. As noted above, MI has traditionally been paid by the borrower, with the lender receiving the benefit of the protection of the insurance. The borrower also is benefitted, in that the use of MI makes it possible for the borrower to make a lower down payment and still qualify for credit. “Deep” MI would presumably involve a different set of costs and benefits, and would likely need to be paid for by different parties for a number of reasons, not the least of which are the restrictions imposed upon required MI coverage by the Homeowners Protection Act of 1998. Relatedly, and as we noted in our suggested additional principle, new credit risk transfer mechanisms should not impose additional costs or complexity on borrowers or originators, and should not have the effect of reducing credit availability. If a borrower, or even an originator, were to be required to pay for “Deep” MI, this principle would be violated. Employing “Deep” MI as a credit risk transfer mechanism would benefit the GSE by reducing the GSE’s credit risk exposure. It follows therefore that the GSEs would be required to pay for “Deep” MI, not originators or borrowers, thus resolving any concerns about increasing cost or complexity (so long as costs are not passed on to originators or borrowers and the GSEs do not impose additional restrictions, filters or other complexity on originators related to front-end risk transfer). If this proves economically viable for the GSEs, such an approach may hold promise.

Additionally, many in the banking industry remain deeply skeptical of the reliability and certainty of mortgage insurance in the wake of the 2008 financial crisis. Despite higher capital requirements and the new Private Mortgage Insurer Eligibility Requirements (PMIERs) put in place by FHFA, many still have concerns about the capacity of the mortgage insurance industry to adequately absorb losses, especially in a steep housing market downturn, and about the potential put-back risk from mortgage insurance companies. During the financial crisis many banks faced difficulties with claims from the MIs based upon technicalities or other refusals of claims. Settlement of these claims was both costly and burdensome and has resulted in a less than robust confidence in the reliability of MI even with recent reforms. Given these concerns, we would recommend that any front-end risk sharing transactions involving borrower or primary lender paid mortgage insurance be, for the foreseeable future, only undertaken at the behest of the primary lender if they so choose. While such transactions may result in lower risk loans, which may benefit both the borrower and the lender, it should be left to the primary market to determine the consumer appetite and viability of any such product.

While all of these are concerns which may inhibit lenders in the primary market from more fully embracing deeper levels of mortgage insurance (along with statutory limitations imposed by the Homeowners Protection Act of 1998), they may not have a significant impact on "Deep MI" transactions undertaken by the GSEs after (or simultaneous with) the sale of loans to the GSEs. With regard to front-end transfers taking place after (or simultaneous with) sale of loans to the GSES, our concerns are geared toward correlated business risks and concentration risks. FHFA notes in the request for input that in a mortgage market downturn, a counterparty with a correlated business risk might need to pay an increased number of claims, including claims to the GSEs, which could result in the counterparty becoming weaker. The strong correlation between the business of the GSEs and that of the monoline business of the mortgage insurance companies calls into question how and whether the GSEs could manage this risk if front-end transfers involving the "deep MI" was undertaken in a large scale fashion. Similarly, given that there are only five large mortgage insurance companies for the GSEs to work with, the concentration risks posed by these arrangements would be significant. We see no meaningful way in which the GSEs can offset this risk given the current state of the mortgage insurance marketplace.

Collateralized Recourse

FHFA's request for input notes that several front-end credit risk transactions in the form of collateralized recourse have occurred, but that these are not expected to become a significant method of credit risk transfer for the GSEs. Nevertheless, we offer the following comments on the potential benefits, and concerns surrounding collateralized recourse transactions.

We would note that the Federal Home Loan Banks (FHLBs) have successfully engaged in collateralized recourse in the form of the Mortgage Partnership Finance (MPF) and Mortgage Partnership Program (MPP) programs for many years. Through these programs, Federal Home Loan Bank members are able to sell loans to the FHLBs while retaining a portion of the risk on their books.

There are key differences between Fannie Mae and Freddie Mac and the Federal Home Loan Banks, which likely make collateralized recourse less than optimal as a scalable method of credit risk transfer. First and foremost is alignment of interests. The FHLBs are cooperative institutions, owned by their members. Members selling loans into the MPF and MPP have a vested interest in loan performance because of recourse and cooperative ownership, ensuring that the loans they sell to their Federal Home Loan Banks (and the credit risk they maintain) are of a higher quality than might be the case with loans sold to the GSEs. Nevertheless, these differences in alignment of interest for the GSEs may be addressed through strong counterparty requirements, and it is notable that the GSEs have engaged in some successful collateralized recourse transactions. ABA has always advocated that changes in authority and regulation of Fannie Mae, Freddie Mac and the Federal Home Loan Banks be undertaken with an awareness that all three are government sponsored enterprises who compete within the capital markets. Wherever practicable within a safety and soundness and public policy framework, authorities granted to one should be granted to all. Recognizing that there are key differences between Fannie and Freddie on the one hand and the FHLBs on the other with regard to ownership structure, and field of eligible counterparties, among others, we continue to advocate that if further credit risk transfer mechanisms are authorized for Fannie and Freddie, they should also be authorized for the FHLBs, and vice versa, wherever practicable taking into account those differences.

The greater concern we have with collateralized recourse methods of credit risk retention are that it may not be possible economically for smaller banks to participate, due to capital and other requirements. Presuming a front-end collateralized recourse arrangement that involves a bank selling loans to one of the GSEs while retaining a portion of the risk of the loan (similar to the FHLB programs) would have a significant capital impact on the bank, as the transaction is not likely to be viewed as a true sale under prevailing accounting standards and Basel requirements. While it is possible that smaller lenders might be able to participate in such credit risk transfers through syndications or aggregations, such arrangements will likely increase costs and complexity and may make it economically unfeasible for them to participate. Additionally, if the collateralized recourse arrangements involve pricing benefits through reduced guarantee (G) fees or other concessions (as they almost certainly would) there is great potential for these arrangements to create an un-level playing field. It seems plausible if not likely that achieving significant scale of such a CRT method would likely create the conditions for large lenders to effectively benefit from volume discounts, which have proven troublesome in the past and which have been remedied through the conservatorship by FHFA mandating flat pricing for all. Nevertheless, some forms of collateralized recourse, such as the programs developed by the Federal Home Loan Banks, have been shown to effectively benefit smaller lenders and their borrowers. If collateralized recourse structures that make economic sense for all participants and which do not lead to an un-level playing field for lenders can be developed, these should be considered as further potential CRT mechanisms.

OTHER CONCERNS

G Fee Impacts

With regard to G fees, one point argued by advocates of more front-end credit risk transfer is that these transactions, and "deep MI" in particular, will lead to lower G fees. While this is certainly possible, it remains speculative. It does not appear that the Freddie Mac pilot (discussed in more detail below) involves lower G fees for lenders whose loans are selected for inclusion in the pilot. Further, as noted above, if lower G fees do result from front-end transfers, there is a possibility of creating an un-level playing field among originators.

Freddie Mac Pilot

At the end of September, Freddie Mac announced that it was moving ahead with a front-end risk transfer pilot program employing "deep" MI mortgage insurance. Under the terms of the pilot, Freddie will provide additional coverage beyond the primary mortgage insurance on 30-year fixed-rate mortgages with 80-95 percent LTVs -- which is placed immediately upon their sale to Freddie Mac. Transactions are executed via a competitive, transparent auction process through a forward credit insurance policy provided by a panel of mortgage insurance company affiliates.

FHFA defines a "front-end" risk transfer as one in which the arrangement of the risk transfer occurs prior to, or simultaneous with, the acquisition of residential mortgage loans. The Freddie Mac pilot meets this definition in that the MI coverage is applied simultaneously with the purchase of the loans. Because the "deep" MI credit enhancement is not applied until after Freddie Mac has purchased the loan, it appears that the transaction is really at the very front of the back end of the process. We therefore take some issue with defining this a true front-end transaction. However, in some ways, this is a better alternative than true "front end" risk transfer, which would take place during the making of the loan and would very likely add cost and complexity for both the borrower and the originator of the loan. Therefore, while it is too early to know the outcome of the Freddie Mac pilot, we are encouraged by the approach being taken – even if we differ with the terminology being applied to it. Of greater importance than terminology will be what the pilot finds with regard to a number of key factors including: do the transactions successfully, fully, and permanently transfer credit risk; do the transactions impact the types of loans Freddie Mac purchases, and from whom; do the transactions provide any economic benefit to originators or borrowers, or conversely, impose any additional costs or burdens on them; and, can the transactions be successfully completed in varying housing market conditions? These are considerations which must be addressed before adopting or expanding such forms of credit risk transfer on a large scale.

Transparency

Regardless of the type of credit risk transfer undertaken by the GSEs, be it front-end or back-end, there is a need for greater transparency in all of the transactions. In order to fully evaluate the promises, failings, and risks associated with any credit risk transfer undertaken, it is essential that greater insight into the economics and the specifics of the individual transactions be made publicly available. Credit risk transfer has the potential to be a significant improvement to the business models of the GSEs or their successors when and if Congress undertakes legislative reform of the government's role in the secondary mortgage market. In order for credit risk transfer to achieve its full potential it will be necessary for policy makers and market participants to have a complete picture of the impacts of each type and variation of credit risk transfer. We recognize that releasing certain types of information for some risk transfer structures may inhibit the ability of the GSEs to attract further counterparties, but we encourage both the GSEs and the FHFA to ensure that as much data as possible is made available without jeopardizing the transactions. Transactions which cannot be fully evaluated will not serve to further the long-term development of risk sharing as a sustainable business practice.

CONCLUSION

ABA appreciates this opportunity to provide input on the further development of credit risk transfer methods. CRT promises to significantly transform the business practices of the GSEs and reduce taxpayer risk, and it is important that FHFA and the GSEs undertake careful and deliberate analysis and experimentation to develop risk transfer methods that work across the greatest variety of market conditions possible, and provide meaningful and permanent transfer of risk from the GSEs and the taxpayers. It is also essential that efforts are undertaken in a fashion that does not jeopardize progress already made, and which is transparent so that approaches can be fully evaluated by the markets, policy makers and those impacted by the programs, including primary market lenders and borrowers.

We hope that our comments are helpful in determining a path forward and stand ready to answer any questions or discuss any issues raised in greater detail.

Sincerely,

Joseph Pigg
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American Bankers Association