600 13th street, N.W.

Suite 400

Washington, D.C. 20005

Tel. 202.289.4322

Fax 202.589.2526

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Federal Housing Finance Agency

Office of Financial Analysis and Modeling

400 7th Street, S.W.

9th Floor

Washington, D.C. 20219

Re: Single-Family Credit Risk Transfer Request for Input

Dear Sir or Madam:

The Housing Policy Council of the Financial Services Roundtable (HPC) appreciates the opportunity to submit these comments in response to the Federal Housing Finance Agency’s (FHFA) request for input on single-family credit risk transfer transactions.[[1]](#footnote-1) Our comments are divided into two sections: general comments and responses to the specific questions posed in the request for input.

**General Comments**

***HPC supports expansion of credit risk transfer transactions.***

During the past three years, the Enterprises, at the direction of FHFA, have steadily increased the amount of risk transferred through credit risk transfer transactions. The structures for these transactions also have evolved to include back-end structured debt issuances, known as Structured Agency Credit Risk (STACR) and Connecticut Avenue Securities (CAS); pool-level insurance transactions, known as Agency Credit Insurance Structure (ACIS) and Credit Insurance Risk Transfer (CIRT); and front-end lender recourse structures, some of which have been securitized.

HPC supports the continued development and expansion of these transactions. Credit risk transfer transactions serve several public policy goals. They reduce risk to the Enterprises, reduce potential costs to taxpayers, and provide valuable insight into the different forms of private capital available to support housing finance.

***HPC believes that credit risk transfers will facilitate housing finance reform.***

The conservatorship of the Enterprises is not a stable, long-term framework for housing finance. HPC supports comprehensive housing finance reform that is based upon the assumption of risk by the private sector. Credit risk transfers can facilitate the transition to such a system. Credit risk transfers identify the risks the private sector will absorb, and at what price, and the risks that must remain with the government. Different credit risk transfer structures also may provide insights on new options or models for broader housing reform. In sum, HPC believes that the expansion of credit risk transfers will not only provide benefits to the current system, but it will provide vital information that will help establish a strong foundation for broader housing finance reform.

Realizing this goal, however, requires that FHFA encourage the development of a variety of credit risk transfer structures. In other words, FHFA and the GSEs should not favor or emphasize one structure over another. Experimentation with a variety of structures will reveal what structures are viable, and what mix of structures may be most effective.

Experimentation with a variety of structures should be accompanied by comprehensive assessments of each structure. These assessments should evaluate the impact of different structures on the liquidity of housing finance; the ability of large and small lenders, insurers, and other stakeholders to participate in the structures; and the impact of the structure on the cost of housing finance. The assessments should be shared with lenders, insurers, investors, and other stakeholders in the housing finance system.

***HPC supports an inclusive mix of structures.***

HPC supports an inclusive mix of both front-end and back-end risk transfer structures. A mix of structures helps to ensure a broad base of investor support. A mix of structures also helps to maintain continuity of credit risk transfers during changes in market conditions and investor appetites. In other words, a mix of structures helps to ensure that there is a diversity of investors. This mitigates against pro-cyclical concentration risk. To be clear, we do not favor one structure over another, nor do we believe that FHFA or the Enterprises should determine what is the best structure or structures. Investor response to different structures should determine which structures are most effective.

***HPC supports the elimination of impediments to different structures.***

The continued expansion of credit risk transfer transactions requires more than a variety of structures; it also requires the elimination of impediments to different structures. One of the most significant impediments is a lack of transparency in the evaluation of alternative structures. In order to expand the pool of private investors willing to participate in these transactions, FHFA and the Enterprises must provide investors with additional information on the alternative structures so they can compare and evaluate each structure and select the most appropriate structure for their risk appetite. This requires FHFA and the Enterprises to release details on the terms and conditions associated with each structure, including pricing and additional details on the performance of different structures over time and the criteria FHFA is using to evaluate structures.

We also urge FHFA to support revisions to existing laws and regulations that impede the expansion of credit risk transfer transactions. We realize that FHFA does not have direct authority over some other laws and regulations that impede certain structures. However, where FHFA finds impediments to the development or expansion of alternative structures, we urge FHFA to be an advocate for appropriate reform. REITs, for example, are major investors in mortgage securities. Yet, they have participated in only 2% of the credit risk transfer transactions to date because the STACR and CAS obligations issued by the Enterprises do not represent a direct interest in mortgages or real estate. Amendments to the Investment Company Act and related tax regulations that treat STACR and CAS obligations as the equivalent of mortgages or real estate would encourage REITs to expand their role in these transactions.

Similarly, a change in the definition of a “commodity pool,” as defined by the Commodities Trading Futures Commission (CFTC), would facilitate the issuance of credit linked notes as an alternative to structured debt issuances. The CFTC already has provided some limited relief to the Enterprises on this issue, but a broader exemption would permit an expansion of the credit linked note structure. As FHFA has recognized, credit linked notes have certain advantages over structured debt issuances. They pose less counterparty risk for investors because the proceeds from the sale of the notes are fully collateralized by the funds held in a trust. They also may eliminate an accounting-related timing mismatch between when the Enterprise actually recognizes a loss and when it is able to recover the loss from the risk sharing investor.

As FHFA and the Enterprises expand the use of front-end structures, other legal and regulatory impediments may arise that require the attention of policymakers.

***HPC supports the creation of a “CRT Advisory Committee.”***

HPC believes that the continued expansion of credit risk transfer transactions depends on the support of all stakeholders. Stakeholders from different sectors of the housing finance industry need to view credit risk transfer transactions as equitable, and not designed to give one group a competitive advantage over another. To facilitate this objective, and to facilitate the continued expansion of credit risk transfers, we recommend that FHFA establish a CRT Advisory Committee composed of a cross-section of stakeholders. The advisory committee for the common securitization platform is a model for this recommendation. A CRT Advisory Committee could provide valuable input to FHFA and the Enterprises into the design of alternative structures. FHFA also could use such a committee to seek input on the types of information investors need to evaluate different structures.

**HPC Responses to Questions**

*Question A1: Are there credit 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 transfer structures that are not included in Section II? Please also provide any comments or views about the principles and risks described in Sections II and III.*

**HPC Response**

Section II of the request for input lists several principles for credit risk transfer transactions that are based upon FHFA statutory mandate as a supervisor and conservator for the Enterprises. Those principles are as follows:

* reduce taxpayer risk;
* economically feasible;
* continuity of core business;
* repeatable;
* scalable;
* counterparty strength;
* broad investor base;
* stability through economic housing cycles;
* transparency; and
* level playing field.

HPC supports each of these principles. Credit risk transfers based upon these principles would facilitate the expansion of these transactions.

The principle of transparency deserves special emphasis. Greater transparency supports most, if not all, of the other principles. It helps investors evaluate different structures. This broadens the investor base, promotes repeatable and scalable transactions, and helps to ensure that transactions are economically sensible, stable, and equitable (i.e., consistent with a level playing field). To promote greater transparency, we specifically recommend the disclosure of data around g-fee pricing, economic capital, and the targeted returns on equity associated with different structures. We also recommend the disclosure of loan level performance data. The Enterprises have provided some loan level information in connection with back-end capital markets structures, and these disclosures have facilitated these particular structures.

The level playing field principle is another key principle. In order for these transactions to continue to develop and expand, they should work for lenders of all sizes. The STACR and CAS transactions have been aligned with this principle since these obligations are sold to investors after lenders transfer mortgages to the Enterprises. Likewise, deeper loan level mortgage insurance coverage would align with the level playing field principle since it would build upon existing industry practices used by lenders of all sizes. Collateralized lender recourse structures, including structures that are securitized, require a scale that is beyond most community banks. However, community banks could participate in such transactions through the use of aggregators.

We recommend that “borrower access” be added to the list of principles guiding credit risk transfer transactions. The Enterprises have an obligation to facilitate access to mortgage credit for credit-worthy borrowers. However, borrower access can be impacted by the fees charged by the Enterprises in connection with different credit risk transfer transactions. Higher guarantee fees, naturally, will increase the cost of a mortgage loan and could limit borrower access. Currently, the Enterprises address borrower access through cross-subsidization. That is, they charge lower credit risk borrowers somewhat more than the risk they actually pose, and then subsidize the cost of credit to higher credit risk borrowers. Cross-subsidization should be factored into credit risk transfer transactions to ensure comparable borrower access under alternative structures, and to ensure that the overall cost to borrowers does not vary between alternative structures. At the same time, cross-subsidization should not be viewed as an impediment to experimenting with different credit risk transfer structures, especially front-end structures that involve entities subject to risk-based capital regimes.

Section III of the request for input lists several risks that should be managed by the Enterprises in connection with credit risk transfer transactions. Those risks are as follows:

* Credit risk;
* Credit-related risks, such as model risk;
* Counterparty risks, including concentration risk and market risk; and
* Other risks, such as interest rate risk.

HPC agrees that these are the major risks associated with credit risk transfer transactions. We also believe that these risks can be managed. For example, as noted above, concentration risk can be avoided through a mix of structures and a diversity of investors. We recommend, however, that FHFA clarify and refine what constitutes counterparty or reimbursement risk. FHFA and the Enterprises should establish a quantitative standard for assessing and comparing this risk under different structures since it is a factor in every type of credit risk transaction.

*Question A 2: 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?*

**HPC Response**

To date, three alternative front-end credit risk transfer structures have emerged: (1) deeper loan-level mortgage insurance coverage; (2) collateralized recourse agreements; and (3) bonds based upon collateralized recourse agreements.

Deeper mortgage insurance is aligned with the principles in Section II of the request for information. Since it is based upon existing industry practices, it is feasible, repeatable, scalable, and economically sensible for the Enterprises. Deeper mortgage insurance does present some reimbursement risk to the Enterprises. However, recent improvements in capital, solvency, and contractual standards imposed by FHFA on mortgage insurers, including contractual provisions that define a mortgage insurer’s obligation to pay claims, have helped to reduce this risk.

Collateralized recourse agreements also are aligned with the principles in Section II of the request for information. They are based upon a standard practice under which a lender retains a portion of the credit risk associated with a loan. Thus, like deeper mortgage insurance, these agreements are feasible, repeatable, scalable, and economically sensible for the Enterprises. Also, like deeper mortgage insurance, these transactions do not disrupt the TBA market. Finally, like deeper mortgage insurance, collateralized recourse agreements do pose some reimbursement risk, but that risk can be offset by collateral posted by the lender in connection with the transaction.

Collateralized recourse agreements that are securitized are particularly effective at reducing risks to taxpayers since the credit risk is immediately transferred to the capital markets. These structures require a scale that is beyond the financial capacity of community banks, but, as noted above, smaller banks could use aggregators to access this structure.

*Question A 3: In considering proposed front-end credit risk transfer transaction structures, how should FHFA and the Enterprises manage the counterparty risk involved in these transactions?*

**HPC Response**

As noted above, collateralized recourse agreements pose some reimbursement risk, but that risk can be offset by collateral posted by the lender in connection with the transaction. Deeper mortgage insurance also presents some reimbursement risk to the Enterprises, but, as noted above, recent capital standards imposed by FHFA on mortgage insurers have reduced this risk.

*Question A 4: 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?*

**HPC Response**

HPC supports the use of pilot programs to test new credit risk transfer structures. Pilot programs can provide useful insights into the design of structures and investor interest in alternative structures. In conducting pilot programs, we urge FHFA and the Enterprises to commit sufficient time and resources to the pilot. It took some time for the back-end capital markets structure to evolve, and presumably other structures will need time to mature.

We specifically recommend that FHFA and the Enterprise test deeper mortgage insurance through a pilot program.[[2]](#footnote-2) Of the various structures discussed in the RFI, only deeper mortgage insurance has yet to be tested in the marketplace. A pilot program would permit the Enterprises and FHFA to fully evaluate how deeper mortgage insurance aligns with the principles and risks identified in Sections II and III of the request for input.

Additionally, while we support pilot programs as a general matter, FHFA and the Enterprises should be careful not to experiment with too many alternative structures. Too many alternative structures could become confusing to investors and negatively impact liquidity.

*Question B 1: What credit risk transfer strategies work best for small lenders? Why?*

**HPC Response**

We believe that small lenders can participate in front-end credit risk transactions. Deeper mortgage insurance would work for lenders of all sizes since it builds upon existing industry practices. And, as noted above, collateralized recourse transactions can be structured to work for small lenders.

*Question B 2: Do other types of front-end credit risk transfer work better for small lenders than collateralized recourse transactions? How so?*

**HPC Response**

Deeper mortgage insurance works well for lenders of all types and sizes. As noted above, collateralized lender recourse structures, including structures that are securitized, require a scale that is beyond most community banks. However, these structures are effective at transferring risk, and small banks can use aggregators to access these structures.

*Question C 1: 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?*

**HPC Response**

Credit risk transfer transactions give FHFA and the Enterprises insights into the market’s assessment of credit risk and the cost of that risk. FHFA and the Enterprises should apply that information into setting both the level of guarantee fees and the frequency of changes in those fees. In doing so, however, the Enterprises and FHFA should take into consideration our proposed “borrower access” principle and set guarantee fees at a level that balances borrower access against credit risk. With the additional information provided by these transactions, FHFA and the Enterprises should be better equipped to find the right balance.

*Question C 2: 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?*

**HPC Response**

There is an inherent trade-off between risk-based pricing and market liquidity and borrower access. Yet, insights gained from credit risk transfer transactions should help FHFA and the Enterprises find the right balance in this trade-off.

**Conclusion**

The Housing Policy Council greatly appreciates the opportunity to provide this input to FHFA and the GSEs on the important issue of credit risk transfer. As stated above, we strongly support continued work on a variety of credit risk transfer structures. The Housing Policy Council and our members would welcome the opportunity to continue to work with FHFA and Fannie Mae and Freddie Mac on these issues. Thank you again for the opportunity to provide input.

Sincerely,



John H. Dalton

President

Housing Policy Council of the Financial Services Roundtable

1. The Housing Policy Council of The Financial Services Roundtable consists of thirty-three of the leading national mortgage finance companies. HPC members originate, service, and insure mortgages. HPC's mission is to promote the mortgage and housing marketplace interests of member companies in legislative, regulatory, and judicial forums.

   [↑](#footnote-ref-1)
2. For purposes of such a pilot program, HPC defines “deeper mortgage insurance” to mean a structure that has three defining characteristics: (1) it occurs at the loan-level; (2) it occurs at origination; and (3) it involves the lender choosing the mortgage insurance provider. [↑](#footnote-ref-2)