October 13, 2016

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

To whom it may concern:

PennyMac appreciates the opportunity to respond to the Federal Housing Finance Agency's (FHFA) Request for Input (RFI) on the merits of Fannie Mae and Freddie Mac (the Enterprises) adopting additional front-end credit risk transfer structures. We are very supportive of the efforts of FHFA and the Enterprises to reduce taxpayer exposure by transferring credit risk to the private markets, which have demonstrated a healthy appetite to assume this risk. Given the dominant role of the Enterprises in the current housing market — which is unlikely to change in the near-term — transferring the vast majority of the credit risk on loans owned or guaranteed by the Enterprises to the private sector is a responsible way to de-risk the taxpayer while continuing to ensure the Enterprises serve their public mission of providing a liquid secondary mortgage market and broad and responsible access to affordable mortgage credit.

We believe that the Enterprises should continue to adopt a variety of different risk transfer structures, each of which have distinct strengths and weaknesses, as the best way to meet FHFA's principles for credit risk transfers as well as mitigate the risks highlighted in the RFI. The introduction of Structured Agency Credit Risk (STACR) and Connecticut Avenue Securities (CAS) in 2013 has been a positive development for the housing finance industry and has helped demonstrate that private capital has interest in investing in safe and sound mortgage credit after the market dislocations of the financial crisis.

Even with the success to date of the STACR and CAS programs, we urge FHFA and the Enterprises to further efforts to transfer risk to private investors through adoption of front-end credit risk transfer structures, including the collateralized recourse structures that PennyMac Mortgage Investment Trust (PMT) has successfully participated in. As noted in the RFI, the

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collateralized recourse structure meets many of FHFA's core objectives, the most evident of which is reducing taxpayer risk through 100 percent collateralization and a stable counterparty backed by permanent capital.

We believe there are **significant benefits for the Enterprises to transfer credit risk to their seller/servicers that are well-capitalized and have the platform to invest in mortgage credit on a programmatic basis for the long-term**. PMT has demonstrated these capabilities with three completed transactions, and a fourth in progress, committing approximately $430 million in capital as of September 30, 2016 to GSE risk transfers that align well with many of FHFA's stated principles, including: reducing taxpayer risk, establishing economically sensible terms for the Enterprises, providing continuity of the Enterprises' core business, being repeatable, scalable, and appealing to a broad investor base and providing stability through economic and housing cycles.

To date, the Enterprises have sold approximately $25 billion in STACR and CAS notes, representing 83 percent of their total credit risk transfers. While these back-end transfers perform well against many of the FHFA's principles, we also think there is risk in concentrating so heavily on these notes for risk transfer. In particular, 88 percent of STACR and CAS notes are purchased by money managers, asset managers and hedge funds from which investors can withdraw their money. As a result, during periods of economic stress or even uncertainty, these sources of capital can be unreliable. By way of contrast, PMT is a public company that seeks a longer-term return on mortgage credit risk over the business cycle with permanent capital from public shareholders.

Moreover, while mortgage insurance is a source of institutional private capital and we are supportive of new risk transfer pilots, as noted in the RFI, we are concerned about the highly correlated business risk with the Enterprises that mortgage insurers pose. Despite the Private Mortgage Insurance Eligibility Requirements (PMIERS) and other efforts to mitigate counterparty risk to the Enterprises, the monoline nature of the mortgage insurers and similarity of their business models to the Enterprises is a risk that needs to be managed. We saw this during the Great Recession when mortgage insurers experienced major losses and proved to be unreliable counterparties for the Enterprises.

A major benefit of the collateralized recourse structure is the alignment of interests between the first-loss owner and the Enterprises. Unlike private mortgage insurers, PennyMac produces, securitizes and services the loans that are acquired by the Enterprises. In the context of its credit risk transfer deals with Fannie Mae, retaining the first loss exposure through a forward agreement ensures that interests are substantially aligned between PMT as the seller and servicer and the Enterprises as the catastrophic guarantor of credit risk. No other credit risk transfer structure implemented to date ensures this level of "skin in the game" which provides an additional layer of protection to the Enterprises and taxpayer.

We also support transparency on all risk transfer transactions. As a public company, PMT discloses a significant amount of information on the economics and performance of our credit risk transfer deals with Fannie Mae, and the information we report on these transactions will become increasingly robust with time.

The remainder of this response addresses your specific questions.

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 that are not included in Section 3? Please also provide any comments or views about the principles and risks described in Sections II and III.

PennyMac believes that the Enterprises should adopt credit risk transfer structures that align the interests of lenders, servicers and the Enterprises as well as promote responsible access to mortgage credit at affordable rates.

- **Collateralized recourse structures substantially align interests of lenders, servicers and the Enterprises**. One of the lessons of the Great Recession was that a misalignment of interests and lack of skin in the game throughout the mortgage supply chain contributed to a deterioration in loan quality that was a major factor in the housing crash. The risk retention rule in the Dodd-Frank Wall Street Reform and Consumer Protection Act sought to address this shortcoming, requiring federal regulators to issue a joint rule-making with the terms under which issuers would be required to retain skin in the game for asset-backed securitizations, generally set at 5 percent.

  As you are aware, to date PMT has completed three credit risk transfer deals with Fannie Mae under the collateralized recourse structure which substantially aligns the interests of the seller, servicer and the Enterprises.

  - <u>Seller</u>: under the terms of these deals, a cash collateral account was funded to secure the first loss exposure of 3.5 percent on $9.6 billion of mortgage UPB originated since May 2015. Because PMT assumes the first loss risk of default, our interests are substantially aligned with the Enterprises under this structure, and we are incentivized to produce high-quality loans that meet the underwriting and quality control standards set forth by the Enterprises.

  - <u>Servicer</u>: PennyMac's incentives are also aligned as the servicer of the underlying loans with the ability to affect their ultimate credit performance. Because the cost of default and foreclosure is first-and-foremost borne by PMT through its first loss position in its credit risk transfers, PennyMac is incentivized to service any delinquencies with proactive loss mitigation strategies that keep homeowners in the home and minimize losses. This is good for both the borrower and PMT, which bears the non-catastrophic financial cost of default.

- **PennyMac's correspondent channel aggregates well-diversified mortgage credit for securitization, facilitating broad access to mortgage credit at lower costs.** As a leading aggregator, PennyMac sources a representative pool of loans from over 450 primarily smaller lenders and banks across the United States. PMT assumes the risk on loans as they are delivered to Fannie Mae; we do not have the ability to pick and choose which loans we will assume the first loss position on. Indeed, PMT's collateralized recourse transactions have "representative sample" language which provides an additional safeguard that prevents selective retention of risk on only the highest quality loans. This is consistent with the model the Enterprises employ to ensure broad access to mortgage credit by charging a guarantee fee that is high enough to cover the desired level of cross-subsidization across different types of loans.

  This model becomes more difficult with credit risk transfer structures — such as deep mortgage insurance — where the credit risk transfer and pricing occurs at the individual loan-level. Such loan-level structures make it more difficult to address the potential for bias towards high quality loans and the effects of risk-based pricing.

A2: How would proposed front-end CRT structures meet and balance the principles outlined in Section II and address the risk outlined in Section III?

While PennyMac believes FHFA and the Enterprises are best positioned to meet their goals through adoption of a variety of structures, we believe the collateralized recourse structure offers distinct advantages across a number of Enterprise principles and risks which we highlight below:

- **PMT's collateralized recourse transactions reduce taxpayer risk by taking the first 3.5 percent loss on a fully collateralized transaction with no pipeline risk to the Enterprises.** In PMT's transactions, cash collateral is posted for the full 3.5 percent first loss. Because the risk transfer is concurrent with delivery of the loans to the Enterprises, the Enterprises have no pipeline risk. By contrast, under back-end structures deployed to date, the Enterprises generally hold pipeline credit risk for the period of time after securities are guaranteed but prior to the credit risk being transferred to the capital markets.

- **In addition to full collateralization, PennyMac is able to aggregate loans from many smaller lenders to provide sufficient volume for the Enterprises to benefit from efficiencies of scale.** As the RFI points out, there are fixed costs associated with credit risk transfers that are not correlated with the size of the transaction. Because PennyMac serves as an aggregator for over 450 sellers, which are a diverse group of smaller lenders and banks across the United States, we are able to deliver a large enough volume of loans to make the transaction more economically sensible to the Enterprises.

- **Because the credit risk is invested in by PennyMac Mortgage Investment Trust — a mortgage Real Estate Investment Trust (REIT) — there is a broad range of investors who gain the ability to invest in the residential mortgage market**. By design, publicly traded REITs are investment vehicles accessible to everyday individuals as opposed to solely sophisticated institutional investors. Any individual investor with a brokerage account can invest in PMT's credit risk transfers by purchasing our New York Stock Exchange listed stock or through a mutual fund that focuses on mortgage REITs.

- **Leveraging permanent capital to assume credit risk minimizes volatility across the business cycle**. STACR and CAS are primarily funded by transactional investors who have a healthy appetite during good times but may pull back during bad or volatile times, as we witnessed in early 2016 when the yield required by STACR and CAS investors spiked. During periods of economic stress, dependence on back-end transfers with transactional investors may leave taxpayers on the hook at a particularly bad time for the economy. In contrast, credit risk transfer structures that rely on permanent capital — such as collateralized recourse transactions — are more stable during periods of stress. PMT is able to leverage long-term capital through its REIT, unlike hedge funds and other transactional investors who have to cycle money more quickly.

- **As a public company, PMT releases a large amount of information on its assets — including credit risk transfer**. PMT is a New York Stock Exchange listed mortgage REIT with total assets of over $5.7 billion and shareholders' equity of over $1.3 billion. As a result, PMT has an obligation to disclose and report meaningful information on the composition, quality and performance of its assets every quarter and will continue to do so.

- **Moving towards actual loss collateralized recourse transactions will reduce model risk and basis risk to the Enterprises**. Over the last year, the Enterprises have moved away from a fixed severity schedule for CAS and STACR and towards actual loss, and investors have generally been receptive. While the GSEs have the best information to price the basis risk, PennyMac believes that it is preferable for investors and the Enterprises to move towards an actual loss structure, which will reduce or eliminate this basis risk.

A3: How should FHFA and the Enterprises manage the counterparty risk involved in these transactions?

FHFA and the Enterprises should manage the counterparty risk by partnering with well-capitalized institutions and requiring cash or other liquid collateral from the counterparty, whether it be a seller/servicer or a mortgage insurer. As noted above, PMT's credit risk transfer deals are fully collateralized transactions. A cash collateral account is posted for the full 3.5 percent first loss. Because collateral is posted concurrently with delivery to Fannie Mae, Fannie Mae has no pipeline risk that the loans will default or that the institution will run into financial difficulties in meeting its obligations prior to delivery.

A4: In developing the CRT programs, the Enterprises have used pilot transactions to evaluate new CRT transaction structures. As FHFA considers proposed front-end CRT 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?

PMT is committed to continuing its collateralized recourse transactions with Fannie Mae and exploring potential risk transfer transactions with Freddie Mac. PennyMac believes that experimenting with a variety of different structures is the best way for FHFA and the Enterprises to meet the principles and mitigate the risks articulated in the RFI. In particular, there are several structural pilots within the collateralized recourse framework that PennyMac would be interested in pursuing with the Enterprises:

1) <u>Alternative credit enhancement to borrower-paid mortgage insurance</u>: In a manner that is consistent with the Enterprises' charter, PennyMac would be interested in working with the Enterprises to take on additional credit risk on high-LTV loans, with the goal of passing savings to the borrower. In particular, PennyMac may be interested in assuming the credit risk required by the Enterprises' charters on loans with an LTV over 80 percent, and would look to work with the Enterprises on whether that risk could be incorporated into the sizing of the first loss position.

2) <u>Offer direct access to Enterprise credit risk to small lenders who deliver to aggregators</u>: PennyMac supports small lenders through its role as the second largest aggregator in the U.S. and would welcome opportunities for interested small lenders to use their capital to co-invest in PMT's collateralized recourse transactions.

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

We believe that a variety of structures can work well for small lenders, as long as the transaction is structured to encourage their participation. As discussed above, PennyMac's business model supports smaller lenders through its correspondent aggregation business. PennyMac specializes solely in mortgages, does not sell additional financial products, nor does it hold customer deposits. Accordingly, PennyMac does not have a business model that competes with small lenders by cross-selling financial products. Rather, PennyMac serves smaller lenders and banks that have a more diversified product suite by giving them access to an efficient aggregator for the mortgages they originate and an outlet to maximize usage of their limited capital.

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

As mentioned in the response to question A4, PennyMac believes there is a way to structure collateralized recourse transactions so small lenders can co-invest directly in the special purpose vehicle if they are willing to put up the capital to receive a proportional return. This serves as a win for both small lenders and the Enterprises as PennyMac retains the aggregation function that provides operational and counterparty simplicity to the Enterprises, allows small lenders to continue to have access to an efficient aggregator while still affording them the opportunity to directly invest in the credit risk transfer if they so choose.

C1: How should FHFA and the Enterprises incorporate information learned through the pricing of CRT transactions into the practice of setting both the level of and frequency of changes in the Enterprises' guarantee fees?

PennyMac believes that the Enterprises should use the market pricing of the various credit risk transfer transactions as an indicator for the appropriate level of guarantee fees that reflects both the risk of catastrophic loss as well as the public policy objectives of providing low-cost secondary market financing for all creditworthy borrowers.

However, the Enterprises should regard STACR and CAS pricing as a useful market indicator, but should not rely solely on these deals to inform the appropriate level of the guarantee fees. As we noted earlier, STACR and CAS are more likely to attract robust interest from transactional investors in good economic times, but these investors may flee during periods of economic uncertainty or stress, leading to significant volatility in the prices of these securities. While PMT's credit risk transfers may not lead to the best execution for mortgage prices in every instance, we believe that they will lead to more consistent pricing over the business cycle. Further, we believe that the Enterprises should use historical pricing points across multiple credit risk transfer structures to develop a framework for a normalized pricing mechanism that ensures consistency across various economic and market scenarios.

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?

PennyMac agrees with the current policy of FHFA and the Enterprises that setting guarantee fees with a longer-term view will provide greater stability over the business cycle. We believe more frequent changes could have negative consequences for consistent access to mortgage credit over the business cycle.

Conclusion

Utilizing a variety of credit risk transfer structures is the most effective way to ensure all the principles and risks outlined in the RFI are best addressed. As the volume of collateralized recourse credit risk transfers is very small compared to back-end structures, PennyMac believes the Enterprises should continue to grow this structure type to complement other existing CRT structures for the unique benefits outlined above. PennyMac appreciates FHFA's attention to this matter and the opportunity to provide input. If you have any questions, please do not hesitate to ask.

Sincerely,

Stanford L. Kurland

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David Spector

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