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Federal Housing Finance Agency
Office of Budget and Financial Management
400 7th St. S.W.
Washington, DC 20219

RE: Comment on FHFA Strategic Plan: Fiscal Years 2018–2022

Ladies and Gentlemen:

Arch Capital Group Ltd. ("ACGL") is pleased to comment on the Federal Housing Finance Agency's ("FHFA") Strategic Plan: Fiscal Years 2018–2022 (the "Plan").

First, we commend the FHFA's balanced approach that promotes safety, soundness and stability in housing finance, while also improving liquidity and expanding access for qualified borrowers. Our interests are aligned in protecting the mortgage market through quality originations, safe and sound business practices, and reducing taxpayer exposure through increased, programmatic ceding of credit risk to private market participants. This process achieves price discovery that provides essential information to policymakers, market participants and homeowners about the potential accumulation of excessive risks in the housing finance system, and helps ameliorate boom and bust cycles.

ACGL is a leading international insurance organization that serves commercial, institutional and individual customers through its mortgage, property-casualty and reinsurance offerings. As the leading provider of private mortgage insurance in the United States[1], and an active participant and innovator in Credit Risk Transfer programs, 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 committed to expanding opportunities for first-time homebuyers, including low- and moderate-income families, many of whom use mortgage insurance to qualify for the purchase of their home. ACGL is well-positioned to provide input on the Plan, and offers the following comments to FHFA on its Strategic Goals for consideration.

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[1] AGCL provides mortgage insurance in the United States through Arch Mortgage Insurance Company, Arch Mortgage Guaranty Company, United Guaranty Residential Insurance Company and United Guaranty Mortgage Indemnity Company (together, "Arch MI").

I. Strategic Goal 1: Ensure Safe and Sound Regulated Entities

FHFA's statutory authority in overseeing the Federal Home Loan Bank System and the Enterprises provides it with the unique opportunity to shape the regulatory framework necessary to ensure sound, balanced regulation as the housing finance system is reformed and transitions, whatever form it may ultimately take. FHFA is empowered with broad authority to oversee prudential operations and to ensure safety and soundness through capital adequacy and strong internal controls, and the activities outlined in Strategic Goal 1 illustrate that FHFA continues to enhance its effectiveness as a prudential regulator. Importantly, FHFA is also charged with ensuring that each regulated entity fosters liquid, efficient, competitive, and resilient national housing finance markets. In ACGL's opinion, it is this charge that should serve as the regulatory foundation upon which housing finance reform proposals are considered, and FHFA should help policymakers filter housing finance proposals against these foundational elements: liquid, efficient, competitive and resilient.

The Mortgage Bankers Association (MBA) published a white paper earlier this year, *GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market,* that outlines a comprehensive housing finance reform proposal that begins to address each of these foundational elements. For example, the MBA recommends:

> Heightened competition by allowing the regulator of the new system (either the Federal Housing Finance Agency [FHFA] or a successor agency) to charter new entities ("Guarantors") to provide for securitization of eligible single-family and multifamily MBS.[2]

The MBA's plan proposes allowing the regulator to charter additional Guarantors in order to permit greater competition on operations, system development, customer service and production development and pricing.[3] ACGL suggests that FHFA begin to develop a regulatory framework "strawman" that could be applicable to Guarantors, including the identification of any gating issues that must be addressed either legislatively or in the period of transition. FHFA should leverage its disciplined approach to capital and risk management to develop a dynamic and countercyclical framework applicable to Guarantors pursuant to the MBA proposal. Similarly, FHFA should analyze each of the other leading housing finance reform proposals, and offer its regulatory perspective of each. Regulatory transparency and providing the private market an opportunity to react will lessen the risk of disruption associated with transitioning to the housing finance system of the future. FHFA is uniquely positioned to provide this important strategic perspective to policyholders and market participants.

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[2] *GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market,* pg. iii, 2017.
[3] Id. at iv.

II. Strategic Goal 2: Ensure Liquidity, Stability, and Access in Housing Finance

ACGL supports FHFA's focus on ensuring liquidity to the mortgage market, with a specific emphasis on equitable access to qualified borrowers in all geographic locations. FHFA took an important step earlier this year in establishing the Enterprises' Duty-to-Serve requirements and publishing its proposed evaluation guidance to ensure the Duty-to-Serve programs create a robust secondary market for mortgages made to low- and moderate-income families for manufactured housing, affordable housing and rural housing. Similar to FHFA's proposed evaluation guidance, this Plan emphasizes monitoring, independent studies and reports that analyze various factors affecting access to housing finance for qualified borrowers and financial institutions. Independent monitoring and evaluation is critical to balancing the competing goals of liquidity and access. ACGL offers the following comments for consideration in how to strike the appropriate balance between these sometimes countervailing interests.

First, and most importantly, the FHFA should continuously evaluate the sustainability of the Enterprises' and the Federal Home Loan Bank's loan programs and production to qualified borrowers in all geographic areas. The FHFA's evaluation should define what constitutes a "qualified borrower," evaluate the geographic risk, and verify that the underlying loans are sustainable and do not present an unacceptable risk of foreclosure. The negative effects of a foreclosure on all parties involved in a mortgage transaction cannot be overstated. Families are uprooted; children often have to change schools; homebuyers lose their homes; their credit is tarnished; and hard-earned savings for a down payment – often the primary source of wealth for a working family – are destroyed, jeopardizing the family's financial security and retirement. As a matter of sound housing policy and ensuring the stability of the system, the FHFA must weigh the risk of loss against the increased access.

As the leading provider of mortgage insurance in the United States, Arch MI's subsidiaries have been insuring loans for over fifty years and have extensive data on the performance of loans secured by very-low down payment loans, also known as 97% loan-to-value ("LTV") loans. Very-low down payment loans are an effective product used in the industry to increase access to qualified borrowers that do not have sufficient savings to make a larger down payment. While low down payment loans can be an effective tool, 97% LTV loans do experience a higher rate of foreclosure compared to loans in which the borrower has greater equity in the property as a result of a larger down payment. Arch MI's data shows that loans with 97% LTVs originated during policy years 1995–2007 are 1.7 times more likely to result in a foreclosure than loans with LTVs below 97%. The frequency of foreclosure on 97% LTV loans is higher due to the borrower's limited equity position. However, this increased frequency is likely tempered by the fact that the home is often appreciating in value, which increases the ability of the borrower to sell the property in strengthening markets without suffering a loss. Without the benefit of house price appreciation, the 1.7 times increase would likely be higher. Given the higher risk of loss associated with very-low LTV loans and the associated sensitivity to geographic risk, the FHFA and the Enterprises must ensure that such products are offered responsibly and are not combined with additional risk factors.

Combining risk factors, such as low FICO scores or high debt-to-income allowances, with very-low down payment loans compounds the risk and may result in unacceptably high rates of foreclosure.

Finally, while the Department of Housing and Urban Development ("HUD") has jurisdiction over the Federal Housing Administration ("FHA"), it is imperative that the FHFA consider the strategic initiatives and loan programs offered by the FHA, which include goals that relate to ensuring broad access to qualified borrowers. Coordination is necessary to eliminate any negative competition or unnecessary overlap between the government programs, which could lead to the accumulation of excess risk and tax payer exposure in the housing finance system. Controlling excessive risks protects individual borrowers, helps keep credit affordable for aspiring homeowners, and ensures stability across the broader market.

III. Strategic Goal 3: Mange the Enterprises' Ongoing Conservatorships

A. Promote credit risk transfer that reduces taxpayer risk by attracting private capital.

ACGL fully supports FHFA's focus on introducing additional private capital into the housing finance system to lessen taxpayer risk by reducing the Enterprises' overall risk exposure. Under FHFA's conservatorship, the Enterprises' strategic model is evolving from buy-and-hold to buy- manage-syndicate risk out to external constituents. This evolution is positive for the overall housing market, and necessitates a significant increase in the volume of private capital to support the U.S. housing finance system. ACGL supports additional types of risk transfer structures that facilitate access to a broader base of private capital than currently provided by the private MI industry. To that end, AGCL has developed a business model that supports an alternative risk transfer structure that both streamlines the transfer of risk to a broad range of private market participants, and encourages the Enterprises' counterparties to compete on the basis of counterparty strength rather than simply racing to a regulatory floor. This alternative risk transfer structure should create efficiencies that ultimately lower costs for borrowers, while reducing taxpayer risk from Enterprise operations. ACGL's alternative structure will enhance the transaction options available to the Enterprises to cede credit losses to private capital while also empowering the Enterprises' to manage their counterparty exposure to private market participants. The FHFA should evaluate and approve additional credit risk transaction options available to the Enterprises, including the business model put forth by ACGL.

B. Oversee Enterprise counterparty eligibility requirements.

The Enterprises' Private Mortgage Insurer Eligibility Requirements ("PMIERs") provide a solid framework for managing their counterparty exposure to mortgage insurers, but ACGL has the following specific suggestions that we believe would significantly enhance PMIERs.

i. The Enterprises should use differentiated loan level pricing adjustments ("LLPAs") for Approved Insurers to further manage their counterparty exposure to mortgage insurers.

While PMIERs should remain the minimum requirement for Approved Insurers, differentiated LLPAs could be used to incentivize an Approved Insurer to maintain more robust claims paying ability or to manage an emerging risk not addressed in PMIERs. The Enterprises have been using LLPAs since 2008 to better align the guaranty fee with a mortgage's credit risk. And while the LLPAs incorporate the benefit of mortgage insurance generally, the current framework does not differentiate among providers on the ability of a mortgage insurer to pay all valid claims in a severe stress scenario. ACGL believes that it is reasonable for the Enterprises to apply a lower LLPA for mortgage insurance provided by a stronger counterparty.

The Enterprises should use internal counterparty ratings of Approved Insurers to set appropriate LLPAs for each Approved Insurer. Section 901.15 of PMIERs authorizes the GSEs to differentially price loans by an Approved Insurer that fails to comply with PMIERs. This authority could be amended to allow differential pricing more broadly based on an Approved Insurer's internal rating. The internal ratings should be primarily based on the PMIERs financial requirements, but should also consider factors such as the strength of the Approved Insurer's risk management program, and the other key non-financial requirements outlined in PMIERs Sections 300, 400, 500, and 600, such as a diversification policy and quality control. Differentiating LLPAs based on transparent financial and non-financial measures provides further incentive to Approved Insurers to maintain counterparty strength.

ii. The Enterprises should publish their counterparty limits for both an Approved Insurer and for the Approved Insurer's entire corporate family.

ACGL understands that the Enterprises establish board and management limits for their counterparty exposure for both an Approved Insurer as well as the Approved Insurer's entire corporate family. ACGL has two recommendations for enhancing these frameworks. First, FHFA should work with the Enterprises to amend PMIERs to transparently define the requirements related to reinsurance, and the anticipated credit an Approved Insurer will receive. More specifically, ACGL thinks it reasonable to grant more favorable PMIERs credit when the reinsurer collateralizes the treaty to its maximum obligation. This added transparency will provide Approved Insurers the incentive to manage their portfolios with strong reinsurance counterparties, thereby strengthening the Approved Insurer and mitigating the Enterprises exposure to Approved Insurers.

Second, FHFA and the Enterprises should provide additional clarity on the group counterparty framework to ensure private market participants can manage their business activities with the Enterprises to avoid breaching a limit that could result in a business disruption. Specifically, ACGL suggests that the FHFA and the Enterprises recognize a deduction to the group counterparty exposure for reinsurance if the reinsurer collateralizes the treaty to its maximum obligation, and the treaty grants the policyholders' access to the collateral if the approved insurer becomes insolvent. Again, granting credit for fully collateralized reinsurance will bring additional private capital to bear in the event of the next housing correction. The inverse is also true, bluntly treating all reinsurance the same creates a disincentive to hold additional capital that would otherwise help stabilize the market.

Conclusion

ACGL appreciates the opportunity to offer its recommendations on FHFA's Plan.

We look forward to working with you and the Enterprises as you implement the Plan in the coming months and years ahead. Please do not hesitate to contact me at 441.278.9179 or arippert@archcapgroup.com regarding our recommendations.

Sincerely,

Andrew Rippert
CEO, Global Mortgage Group
Arch Capital Group Ltd.