PIMCO

Via Electronic Submission

October 27, 2017

The Honorable Melvin Watt
Director
Federal Housing Finance Agency
Washington, D.C. 20224

Dear Director Watt,

Thank you for inviting public input on the *FHFA Strategic Plan: Fiscal Years 2018-2022.* We appreciate the opportunity to provide comment and do so in the capacity as one of the largest investors in Fannie Mae and Freddie Mac ("Enterprises" or "Agencies") mortgage backed-securities (MBS) and non-Agency mortgage whole loans and securities (RMBS) globally. As you may know, PIMCO is the largest active fixed income manager globally, and as of 9/30/2017, we manage $1.7 trillion of assets for millions of individuals and thousands of institutions globally; in all cases, we function in a fiduciary capacity and are legally obligated to act in the best interests of our clients always.

As large market participants in the U.S. mortgage markets who are committed to the healthy functioning, liquidity and stability of markets, we are uniquely positioned to offer insights and feedback to the FHFA on its strategic and performance goals and proposed strategies in which to advance those goals. Broadly speaking, we believe the FHFA's focus on safety and soundness, stability, liquidity, access to credit and managing the Enterprises' conservatorship are well-placed, although in certain cases we have comments on how those goals should best be attained.

Below, we elaborate on those areas where we agree with the FHFA, and in those certain cases where we disagree, we propose an alterative recommendation for the FHFA's consideration. The issues we opine on include: i) the importance of attracting private capital to the housing finance market through the Enterprises' credit risk transfer programs as well as encouraging commonsensical reforms to revive the non-Agency loan and securitization markets; ii) concerns we have with the Single Security proposal as it stands now and the importance of sequencing the Single Security initiative only *after* broader housing finance reform is pursued; iii) the market's response to the declining capital levels at the Enterprises; and iv) the current construct of mortgage servicing rights and recommendations for improvement.

## I. The importance of attracting private capital to the housing finance market in order to reduce taxpayer risk and to promote liquidity in the housing finance market

We commend FHFA's goal to introduce "additional private capital in the housing finance system to lessen taxpayer risk" and to do so in a way that "does not reduce liquidity or adversely impact the availability of mortgage credit."[1] We believe that increasing private capital should be pursued in two ways: 1) through the continuation and expansion of the Enterprises' credit-risk-transfer (CRT) programs, which we believe work in part because of their "back-end" risk-transfer nature; and 2) by making responsible changes to the well-intentioned-but-imperfect Dodd-Frank regulations that have discouraged private capital, and in doing so, have decreased access to mortgage credit.

### 1) Credit risk transfer should continue and be expanded, although we believe it functions well only in its current "back-end" form

We fully support the Enterprise's credit risk transfer (CRT) programs and have invested in many of these transactions on behalf of our clients. We believe that one of the critical reasons for the CRT program's success is its "back-end" nature; specifically, by buying mortgage loans first (in which case the government guarantee "attaches") before commencing with the credit risk transfer process, the Enterprises ensure that mortgage originators know the price of the loans they are going to receive when they ultimately sell the loans they originate. Accordingly, the originators know what rates to publish on their rate sheet each day. Indeed, from the mortgage originators' perspective, this is the same process that exists regardless of whether a CRT transaction occurs or not. This process ensures the stability and continuity of the to-be-announced (TBA) market and the national mortgage rate – the ability for a borrower to get the same mortgage rate regardless of whether he lives in San Francisco, California or Spartanburg, South Carolina.

This compares to many of the housing finance proposals currently being circulated, which envision a "front-end" credit risk transfer process – i.e., a process in which in which originators bid out the credit risk upfront before the government guarantee attaches. Front-end CRT (without mortgage insurance or "MI") would entail mortgage originators contracting with private-market counterparties to pre-place the risk through a bidding process with investors before selling the loans to the Enterprises. This untested process would require that originators determine the best price for the risk of the loans in each geography and only then publish their corresponding rate sheets. The transmission of mortgage credit would grind to a halt with this cumbersome process, but most importantly, the market-clearing price for Spartanburg, South Carolina would be dramatically different (read higher) than it would be for San Francisco, California. This

[1] *FHFA Strategic Plan: Fiscal Years 2018-2022*, p. 12

would be anathema to goal of preserving a national mortgage rate and ensuring stability and liquidity in the housing finance market.

While some have advocated that front-end CRT utilize private mortgage insurance (MI) on loans, we believe that this accomplishes little of substance with respect to risk transfer. Unlike back-end CRT, which is fully funded, front-end CRT though MI is contingent on the willingness-and-ability of MI companies to pay claims. MI serves a purpose, but prudently expanding MI would require substantially more capital given the additional risk this would entail and the highly correlated nature of their business than the MI companies have currently.

An additional benefit to "back-end" CRT is that by virtue of the fact that the Enterprises first buy the mortgage loans prior to the credit risk transfer, investors feel confident that their interests will be protected; this is because the Enterprises have a demonstrated history of enforcing their contracts (e.g., putting back loans) and have aligned interests with investors more broadly. We would argue that this dynamic – investors feeling confident that their rights will be protected – is one of the key reasons why investor demand has been so high for these back-end CRT transactions.

**2) Policymakers should consider commonsensical reforms to revive the private mortgage market, which they should prioritize first before reforming the Enterprises**

We believe a core component to shrinking the Enterprise's footprint is to revive the non-Agency mortgage loan and securitization market, which remains nearly dormant with significantly smaller issuance and volumes relative to pre-2008 levels. This is in part due to the legal uncertainty and higher costs associated with the regulatory regime imposed on the non-Agency market after the financial crisis. The higher costs have led originators and securitizers to effectively exit the non-Agency market, while the increased legal and other associated risks have caused private investors, who are oftentimes fiduciaries such as PIMCO, to withdraw from the non-Agency market in favor of other markets with fewer unknowns and more investor protections. Practically, this means that 1) residential mortgage originations are dominated by the Enterprises, thereby putting more pressure on the government's balance sheet, and 2) many borrowers who want to get a mortgage loan simply cannot.

As fiduciaries and large market participants, we have no interest in returning to the pre-crisis years of lax underwriting and poor-performing loans. However, we believe that in some narrow respects, the pendulum has swung too far and that minor regulatory and legislative changes could help return private capital to the mortgage market in a responsible manner, which would facilitate increased access to mortgage credit for those borrowers who want it. Importantly, we would argue that reviving the non-Agency whole loan and securitization markets should happen *before* broader reform of the Enterprises; without ensuring there is a viable, functioning private market, it will be nearly impossible to shrink the Enterprises' footprint without significant disruption to the housing finance market and to homeownership broadly.

We believe the following reforms should be pursued by policymakers (we note that FHFA only has limited jurisdiction on these issues but are including all of our recommendations for the sake of completeness):

- **Imposing a best-interest standard on trustees and servicers in PLS (private-label securitizations) to increase investor protections.** During the housing boom, mortgage originators often packaged non-Agency mortgages into pools and sold them into mortgage-backed PLS trusts. The PLS trusts issued securities collateralized by these loans, largely to institutional investors, including PIMCO. The servicers of the loans and the trustees of these PLS trusts, however, frequently had conflicts of interests (e.g., they were owned by mortgage originators) and regularly failed to protect investors from pervasive bad practices by originators, such as poor underwriting and predatory lending. Because investors, such as PIMCO, did not (and still do not) have any standing to take action against the mortgage originators, they invariably had to (and still have to) bear the brunt of losses on these loans. The investor experience as a PLS certificate holder is markedly different than that of an Enterprise certificate holder mainly as a result of the fact that the Enterprises are able to enforce their contracts with originators (and do so) and serve as the servicers. As the FHFA is invited to participate in the discussions about comprehensive housing finance reform, we hope that their experience in policing the market is emphasized and echoed as a necessity for the full realization of the PLS market.

  We believe that each party involved in PLS trusts should be held fully accountable in a manner that that is already exercised by the Enterprises which safeguards the interests of the borrowers and the investors. To achieve this, we believe trustees and servicers need to have an explicit duty to act in the best interest of PLS investors at all times. We maintain that this would result in higher-quality loans in PLS trusts and would greatly reduce the risk of servicers and trustees acting against the interests of PLS trusts, either through self-dealing or by inaction.

- **Expanding safe harbors under the Ability to Repay rule to eliminate the expansion of assignee liability for investors under Dodd-Frank's Ability to Repay rule.** Currently under Dodd-Frank, mortgage investors are liable for mistakes made by lenders in the mortgage origination process for certain mortgages that are not deemed "Qualified Mortgages." Since investors have no role or discretion in the mortgage origination process, we believe this is not only nonsensical, but also has the practical effect of discouraging investors from purchasing the loans given that such a liability is nearly impossible to price. Mortgage originators should be liable for their own underwriting practices, but investors buying these loans in the secondary market

– who have no way to control the origination process – should not be. As FHFA is invited to consult with the Consumer Financial Protection Bureau in the 5 year look-back on the "Qualified Mortgage" mortgage rules, we hope that the banner of safe harbors for investors is raised.

- **Allowing for regulatory cures for numerical errors under TRID (aka, TILA-RESPA).** TRID, the series of documentation and disclosures that provides borrowers with more information about their loans, represents a meaningful and necessary improvement to borrower loan disclosures. However, given how complex it is, numerical errors in the documentation often occur (e.g., a mistake in the borrower's zip code). Although these errors are typically trivial and do not result in any harm to consumers, they are nevertheless considered to be violations – for which investors can ultimately be held accountable under TRID. Since no mechanism exists to correct these errors, investors will either demand a significant discount for a mortgage to compensate for the potential liability or walk away altogether because the liability is too difficult to price. Allowing for a mechanism to rectify these trivial errors is important in bringing back private capital to the non-agency market.

- **Expanding the "Qualified Mortgage" safe harbor to jumbo loans.** Currently, many credit-worthy jumbo loans are not considered Qualified Mortgages and therefore do not receive safe-harbor status from a myriad of requirements under Dodd-Frank purely because of their size. Investors who otherwise would be interested in investing in jumbo loans, which are often very high quality, do not because of the assignee liability attached to non-QM loans (discussed earlier in point 2). We believe that if a loan adheres to all other QM criteria eligible for purchase by the Enterprises, it should qualify for QM status. We think this would lead to credit expansion and more liquidity in the non-Agency market.

- **Eliminating (or scaling back) the 5% risk retention requirement in light of its redundancy with the Ability to Repay rule.** The Ability to Repay rule, which is part of the Dodd-Frank Act, requires mortgage lenders to verify that mortgage borrowers can in fact pay back their loans; by contrast, in the period leading up to the financial crisis, many mortgage loans were made regardless of the ability of the borrower to pay. We believe this rule has been incredibly effective, eliminating the most dubious bubble-era underwriting practices and raising underwriting standards broadly. Given the Ability to Repay rule's success, we contend that the 5% risk retention requirement is redundant and is yet another headwind for both originators and investors from participating in the private mortgage market. We think the 5% risk retention threshold should be eliminated – or at the very least scaled back to be commensurate with the risk of the underlying collateral. This is consistent with the Department of Treasury's recommendations regarding risk retention.[2]

## II. FHFA's goal of increasing secondary market liquidity in the mortgage market through the advent of a "Single Security" is misplaced unless significant changes are made

Currently, Fannie Mae and Freddie Mac separately issue and guarantee mortgage-backed securities that are backed by pools of residential mortgage loans. For a variety of reasons, including historically faster prepayment speeds and reduced market liquidity, Freddie Mac securities trade at a discounted price (and higher rates) to those issued by Fannie Mae. Consequently, in order to induce mortgage originators to do business with Freddie Mac, Freddie Mac has had to subsidize mortgage originators (called a "mortgage adjusted price" or "MAP"). As the FHFA has indicated, the Single Security proposal would seek to eliminate price differences between Fannie and Freddie - and therefore eliminate the need for Freddie to subsidize originators - by creating a new, unified mortgage-backed security, which would allow new Fannie Mae or Freddie Mac securities to be issued under a Single Security structure and would also allow legacy Fannie and Freddie securities to be converted into the new Single Security structure. The FHFA has asserted this development would reduce costs while also increasing mortgage market liquidity by unifying the two markets.[3]

While we can understand why this plan may sound appealing in theory, we have several significant concerns with the proposal as it stands now and would not support the proposal until these concerns are addressed. They include:

- **A race to the bottom.** Today, Fannie Mae and Freddie Mac compete with one another on the quality of the mortgage-backed securities they issue. If Freddie issues securities backed by mortgage loans with less appealing characteristics for investors (e.g., credit quality, prepayment characteristics), the market will punish Freddie Mac by demanding a discount on the price of those securities and vice-versa. Under the Single Security proposal, this ability to police Fannie and Freddie and differentiate on price to ensure each entity is delivering the best product to the marketplace would be lost. Without the market as the enforcer, Fannie and Freddie would lose their incentive to compete on the quality of their product, which could lead to a "race to the bottom" effect. This would likely lead to a lower quality security for investors. While the FHFA has asserted that there will be alignment between the securities issued by Fannie and Freddie under the new Single Security structure, we are not aware of what mechanism FHFA has to ensure this exists under the current proposal.

[2] *"A Financial System That Creates Economic Opportunities Capital Markets,"* Department of Treasury, October 2017, p. 101

[3] *FHFA Strategic Plan: Fiscal Years 2018-2022*, p. 13

Any clarification by the FHFA regarding this would be welcome.

- **Perversely, markets could become less liquid, leading to higher mortgage rates.** As FHFA has stated in its strategic plan,[4] one of the primary objectives behind the Single Security proposal is to improve liquidity in the mortgage market; however, as currently proposed, we have two issues with that premise: 1) the mortgage market is currently one of the most liquid, well-functioning markets worldwide, so the proposal is solving for a problem that, in our view, does not exist; and 2) liquidity would only improve from its already-strong levels if holders of legacy Fannie and Freddie securities chose to "convert" into the new Single Security. The problem with the latter is that as conceived now, there is no incentive to convert to the new security, as holders of legacy securities would be charged a fee for doing so under the current proposal.

  Practically, if investors do not convert, the market could ultimately become trifurcated with smaller floats in each segment: Legacy Fannie Mae MBS, legacy Freddie Mac and a new Single Security market. This is similar to the experience in 1990 when Freddie Mac introduced a new security (Freddie "Golds") and investors chose not to convert, which led to market fragmentation and reduced liquidity for decades.

- **Dual guarantee could cause confusion during times of stress.** Under the proposal, during times of stress, there may be confusion surrounding which entity is the ultimate guarantor of the security if the issuer of the new Single Security is different from the one that packaged the loans (e.g., Fannie is the new issuer but the underlying collateral loans are packaged by Freddie). We worry that it is unrealistic that Fannie and Freddie, which are two legally separate entities, will unconditionally promise to guarantee the others' loans without having ever evaluated the underlying credits backing the loans. We think this could be addressed with explicit contractual language, but investors need to be able to review this language well in advance.

Given these concerns our support for the Single Security initiative would be conditional on the following changes:

- **Conversion must be free:** As mentioned above, we believe the only way the Single Security proposal will be able to deliver on its promise to increase market liquidity is if there is wide-spread conversion to the new unified security. Under the existing proposal, there would currently be a cost to conversion, which we think will dissuade investors to convert, leading to a more fragmented market and likely higher mortgage rates. In order to avoid this, we believe that FHFA should not only abolish the proposed fee, but instead offer an incentive to investors who convert within a distinct

[4] *FHFA Strategic Plan: Fiscal Years 2018-2022,* p. 15

window of time. This could be funded from the savings that will result from Freddie no longer having to pay the MAP fee to mortgage originators. While early adoption would not eliminate many of the other flaws of the program, such as the potential for security degradation, high participation in the conversion would greatly reduce the chances of fragmenting the market and increasing costs for homeowners.

- **Performance of the securities must be monitored and dispersion must be minimized; alignment is not sufficient.** As we discussed above, the advent of the Single Security will preclude market forces from being able to police Fannie and Freddie to ensure that the quality of the securities offered does not suffer. In order to avoid a "race to the bottom," FHFA must be vigilant about monitoring and minimizing any dispersion and ensuring that performance does not degrade in unison over time. Simply focusing on "alignment," as the FHFA has said it will do, will not necessarily achieve this goal. Indeed, under the current proposal, if Freddie Mac securities are already performing poorly, Fannie Mae creating equally poor securities would be theoretically acceptable by FHFA as they would be "aligned," but every participant would be made worse off: the marketplace would receive lower quality securities and prospective buyers would face higher mortgage rates.

- **Sequencing: Comprehensive housing finance reform should come first.** Given the healthy functioning of the Agency mortgage market today and the real chance of significant disruption from the rollout of the Single Security initiative, we believe that FHFA should put the Single Security proposal on pause and wait for Congress to advance housing finance reform – an issue that both Chairman Crapo and Ranking Chairman Brown on the Senate Banking Committee have said is a priority. We believe that waiting is warranted since many of the issues that the Single Security proposal is trying to address would be addressed in housing finance reform, especially if the existing implicit full faith and credit guarantee becomes explicit for Fannie and Freddie. Indeed, adding a full faith and credit guarantee to the Single Security would render it definitively superior to existing Fannie and Freddie securities, increasing the price of existing securities, and lowering the borrowing costs for new homeowners. It would also render the dual guarantee issue we mention above obsolete.

## III. As investors, we do not believe the market will react negatively to declining capital at the Enterprises or a potential "draw" on funds at Treasury

Policymakers, including FHFA Director Watt,[5] have expressed a growing concern about the dwindling capital levels at the Enterprises per the Senior Preferred Stock Purchase Agreement (PSPA). Among other issues, there has been concern about how the mortgage

[5] Testimony of The Honorable Mel Watt, Director FHFA, "Sustainable Housing Finance: An Update from the Director of the Federal Housing Finance Agency," House Financial Services Committee, October 3, 2017.

market may react when the Enterprises' capital levels go to zero and are forced to "draw" additional funds from Treasury if and when the Enterprises have an unprofitable quarter.

While we can understand policymakers' concerns, we, as one of the largest non-government investors of Enterprise-issued mortgage back securities, believe that a draw of additional funds by Fannie or Freddie on Treasury would not impact our appetite as investors for these securities and similarly would not be a market event. For one, Fannie and Freddie have a collective credit line at Treasury of $258 billion that they can draw on at any time. To put that amount in context: During and right after the financial crisis, which represented the most significant downturn in the housing market we have seen in modern history, the Enterprises drew a total of $188 billion from Treasury, far less than their current available line of credit they can tap. Moreover, as you know, FHFA constantly runs stress tests and has found that if the housing market were to decline by 25% from today, the Enterprises would still have $71-$148 billion of capital from which to draw. Lastly, allowing the Enterprises to retain a $3 billion capital cushion, which they were allowed to do in 2013, does not seem sufficient in case of a market downturn, so the debate about de minims capital levels seems beside the point.

Instead of focusing on small capital levels, we would advocate that policymakers focus on the dimension investors most care about: Codifying the explicit government guarantee. We believe that any viable housing finance reform will need to include an explicit guarantee of both legacy and future Enterprise mortgage-back securities in order to avoid significant disruption to the secondary mortgage market and by extension the housing market as a whole.

We would also be remiss if we did not express our opposition to any proposal that resembles the so-called "recap and release" approach. As we outline in a recent viewpoint, "Housing Finance Reform: First Things First," we do not believe such a proposal contains the necessary elements required to preserve liquidity in the housing finance markets and to ensure adequate access to mortgage credit.

## IV. Revisiting the current construct of mortgage-servicing rights (MSRs)

In order to advance the FHFA's performance goals related to promoting liquidity and stability in the housing finance markets and expanding access to mortgage credit, we believe the current construct of mortgage-servicing rights (MSR) should be reconsidered.

As you know, mortgage-servicing rights are created when the right (obligation) to service mortgage loans are contractually separated from the underlying mortgage loans, in which case the seller retains the right to service the loans although does not own the underlying loans. We agree with several policymakers, including the Federal Reserve Board of

Governors and the Federal Depository Insurance Corporation, which found in a joint 2016 report to Congress that MSRs are high-risk, volatile and capital-intensive assets that require sophisticated financial skill to value and hedge. [6]

Given the uncertainty and subjectivity of MSRs coupled with the infrequent trading and a lack of homogeneity of MSR pools that do trade, MSRs are characterized as illiquid assets for accounting purposes. Due to the nature of the asset and its accounting standards, according to the aforementioned report, MSRs are prone to overvaluation and book values may not be able to be realized. Indeed, MSRs comprise the majority of the book value of most mortgage companies. Since MSRs are volatile, capital intensive and illiquid, they increase the cost of mortgage-banking equity, as earnings are comparably volatile and cyclical. In turn, the demand for non-bank mortgage-banking capital coupled with an increasing lack of demand from banks for MSRs raise borrower mortgage rates to compensate. Consequently, MSRs detract from overall liquidity in mortgage markets.

Historically, the vast majority of MSRs have been owned by banks, but increasingly fewer MSRs are owned by banks and instead are owned by non-bank mortgage banking companies ("non-banks"). From a borrower's perspective, this may be a positive development, since many non-bank servicers specialize in delivering high-touch customer experiences, which promote timely payments and better outcomes when loans are delinquent. From a market stability perspective, however, the rise of non-bank servicers is cause for some concern, as they are not as well capitalized, and perhaps most significantly, their book value is comprised almost entirely of illiquid assets, namely MSRs. Neither raising nor lowering contractual servicing fees is likely to ameliorate what is fundamentally an accounting and tax treatment problem caused by the characterization of the asset. Indeed, changing servicing compensation levels risks limiting access of institutions that are either currently market participants or those that may otherwise participate.

Accordingly, the FHFA should explore changing the nature of the Enterprises' utilization of mortgage servicers; indeed, since the Enterprises acquire the whole mortgage loan, they are in a unique position to change this dynamic. A more stable, more liquid mortgage market with the expectation of greater institutional access could result from the Enterprises retaining MSRs (which is allowed under their charters) and subsequently utilizing their current servicers as sub-servicers. The Enterprises are best positioned to own MSR through superior access to credit and sophistication. They also currently exercise oversight of servicers contractually through the Servicing Guides and operationally, so little or no additional infrastructure is necessary. This alteration of

[6] https://www.federalreserve.gov/publications/2016-capital-rules-mortgage-servicing-assets-Risks-to-Firms-Holding-Mortgage-Servicing-Assets.htm

servicer utilization would seemingly eliminate the destabilizing impacts of banks and non-banks owning MSRs.

**Conclusion**

Again, we appreciate the opportunity to provide feedback on the FHFA's objectives and proposed strategies to advance those goals and look forward to continuing our dialog with the FHFA and other important policymakers in Washington on these issues that are so vital to the healthy functioning of markets and to the economy overall.