AON

November 24, 2021

Mr. Clinton Jones
General Counsel
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20219

Re: RIN 2590-AB17, Enterprise Regulatory Capital Framework Rule – Prescribed Leverage Buffer Amount and Credit Risk Transfer

Dear Mr. Jones:

Thank you for the opportunity to respond to FHFA's proposed amendments to the 2020 Enterprise Capital Risk Framework ("ERCF"), as well as additional questions included in the proposed amendments ("FHFA's 2021 Amendments").

Upon reviewing FHFA's 2021 Amendments, we recognize they reflect FHFA's thoughtful and considered reform of the current ERCF. The changes would increase and diversify the capital supporting Fannie Mae and Freddie Mac (collectively the "Enterprises"). The changes also recognize the importance of credit risk transfer and the need to include the private markets as holders of that risk.

Aon has worked closely with the Enterprises, the market, and the FHFA to build multi-line insurance-based credit risk transfer ("CRT") since 2012. Over the years the programs have matured and, working with both the Enterprises and FHFA, Aon has helped adapt the needs of the Enterprises with the abilities of the markets. This relationship has worked exceptionally well, and we commend FHFA for its recognition of the relationship.

Aside from the proposed changes, FHFA's 2021 Amendments include additional questions soliciting commentary on several areas. Our formal comments provide commentary on potential, additional enhancements to ERCF.

We look forward to further discussion with FHFA to improve the CRT programs and increase private sector participation in public sector risk.

Joe Monaghan

Global Growth Leader, Aon Reinsurance Solutions

CEO, Aon Public Sector Partnership

Amendments to the Enterprise Regulatory Capital Framework

Introduction

Thank you for the opportunity to respond to FHFA's proposed amendments to the 2020 Enterprise Capital Risk Framework ("ERCF"), as well as certain additional questions included in FHFA's Proposed Rule to Amend Enterprise Regulatory Capital Framework ("FHFA's 2021 Amendments").

Aon has worked closely with Fannie Mae and Freddie Mac (collectively the "Enterprises"), the insurance and reinsurance industries, and FHFA to build multi-line (re)insurance-based credit risk transfer ("CRT") since 2012. The Enterprises selected Aon, a diversified professional services firm, as their broker to help create CRT, including Agency Credit Insurance Structure (ACIS), Credit Insurance Risk Transfer (CIRT), Multifamily Credit Insurance Pool (MCIP), and Multifamily Credit Insurance Risk Transfer (MCIRT). These transactions shift risk away from the Enterprises to a diversified group of highly rated and well capitalized multi-line insurance and reinsurance companies.

At the time of its proposal in 2020, FHFA's stated goals for ERCF were to increase the quantity and quality of capital underpinning the Enterprises so they could safely and soundly support and stabilize the secondary mortgage market across housing cycles. In the comments we submitted, we agreed with FHFA that it was important for the Enterprises to hold a variety of capital sources to ensure their safety and soundness across economic cycles. However, we expressed concern that the proposed adjustments to the capital credit for CRT were counterproductive to that goal and that the adjustments would disincentivize the use of CRT. We incorporate by reference Aon's prior comments and suggestions in response to RIN-2590-AA95, as submitted on August 31, 2020 ("Aon's 2020 Comments")[1].

Aon's analysis validates that the ERCF amendments outlined in FHFA's 2021 Amendments produce a CRT treatment that better recognizes the risk reduction that these structures provide. Further, the changes reflect FHFA's thoughtful and targeted approach to improve ERCF, lessen potential deterrents to Enterprise risk transfer, and encourage the Enterprises to hold a variety of capital sources to ensure their safety and soundness across economic cycles.

[1] https://www.fhfa.gov//SupervisionRegulation/Rules/Pages/Comment-Detail.aspx?CommentId=15657

FHFA's 2021 Amendments' stated desire to incentivize the Enterprises to distribute acquired credit risk to private investors through CRT rather than buy and hold the risk is further supported by a strong reinsurance industry that is committed to partnering with the Enterprises across all economic cycles. Since the beginning of the 2020 pandemic the ACIS & CIRT programs have transferred over $13B of limit. This fact is a strong testament to that partnership.

In identifying these partners, the Enterprises employ a mature and sophisticated counterparty selection process and ongoing counterparty monitoring process. These processes, overseen by FHFA, are managed by the Enterprises' robust counterparty teams and are informed by both public and non-public data provided by the (re)insurers, as well as additional market review and intelligence. These approved counterparties are highly rated and diversified (re)insurance entities, backed by significant capital. The top-15 entities participating on Enterprise CRT are backed by well over $110B of capital. In addition to the strength of individual, approved counterparties, the industry, as a whole, has consistently demonstrated the commitment and ability to pay claims. Moreover, while certain critics argue that these transactions are only partially collateralized, it is worth highlighting that these transactions are supported by dedicated collateral, held in trust for the Enterprises. These same (re)insurers (who bear more than 90% of the risk in these transactions) have currently dedicated cash equivalent collateral greater than 4 times the projected credit loss under an immediate replay of the 2008 global financial crisis, before taking into consideration any future premium. Adjusting the projected losses for projected future premium, the dedicated collateral can cover over 6 times the projected losses from an immediate nationwide down 35% HPA scenario.

Beyond the changes proposed in FHFA's 2021 Amendments, Aon believes that there are two immediate incremental enhancements which will further align ERCF with the Enterprise's economic risk exposure and promote a stronger housing finance system. The discussion below highlights these specific suggestions and considerations. We appreciate FHFA's collaborative approach and look forward to broader discussions around changes to ERCF and specific enhancements to the CRT transactions.

In the rest of the document we:

- outline FHFA's proposed amendments to ERCF;
- illustrate their impact using a simplified example;
- describe Aon's two incremental proposed enhancements; and
- outline two principles for evaluating additional changes to ERCF.

FHFA's 2021 Proposed Amendments to ERCF and their Impact

FHFA states that the ERCF refinements in their 2021 Amendments will lessen the potential deterrents to Enterprise risk transfer.

The specific proposed adjustments to ERCF are:

1. Replace the fixed prescribed leverage buffer amount (PLBA) equal to 1.5 percent of an Enterprise's adjusted total assets with a dynamic PLBA equal to 50 percent of the Enterprise's stability capital buffer as calculated in accordance with 12 CFR 1240.400;
2. Replace the tranche risk weight floor of 10 percent on any retained CRT exposure with a 5 percent tranche risk weight floor to any retained CRT exposure; and

3. Remove the requirement that an Enterprise must apply an overall effectiveness adjustment to its retained CRT exposures in accordance with the ERCF's securitization framework in 12 CFR 1240.44(f) and (i).

Changes to the Leverage Ratio Requirement

FHFA's 2021 Amendments will remove the fixed PLBA requirement of 1.5% of assets and replace it with the stability capital buffer from the Risk Based Capital (RBC) framework, which is commensurate to the Enterprises' market share of the US mortgage market. The proposed change will reduce the overall leverage capital requirement for the Enterprises by 25%, from 4% to approximately 3% as of March 31, 2021.

FHFA acknowledges that a leverage ratio that exceeds RBC throughout the economic cycle could lead to undesirable outcomes. The Enterprises will be incentivized for incremental risk taking, while they will slow down or completely stop issuing new CRT transactions because they do not receive incremental capital credit. Inconsistent CRT issuances may be disruptive to the market and may limit the future effectiveness of this important risk management tool.

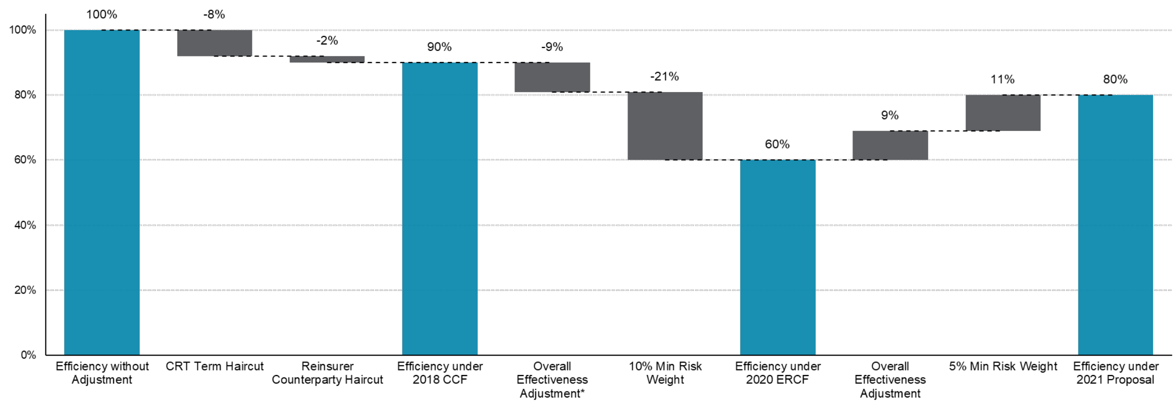
In Aon's 2020 Comments, we proposed a leverage capital requirement that was lower than the overall ~3% requirement in FHFA's 2021 Amendments. We support FHFA's proposed amendments to lower the leverage capital requirement, and further suggest that FHFA continues to study the relationship between leverage capital and RBC over a variety of scenarios to ensure their comfort that the proposed amendments both (1) sufficiently provide incentives for CRT to be a reasonably sized component of the Enterprises' total capital, and (2) result in a leverage capital requirement that only backstops the RBC requirement, so that it is only binding in the intended scenarios. As of March 31, 2021, it appears that both criteria above are satisfied.

Changes to the Risk Based Capital Requirement

FHFA's 2021 Amendments make two changes that provide additional capital relief for CRT under the RBC framework, namely by eliminating the Overall Effectiveness Adjustment (OEA) and reducing the tranche risk weight floor from 10% to 5%.

Graph 1 shows a simplified example of the RBC capital relief at the inception of a CRT reinsurance transaction attaching at expected loss and detaching at ERCF stress loss.

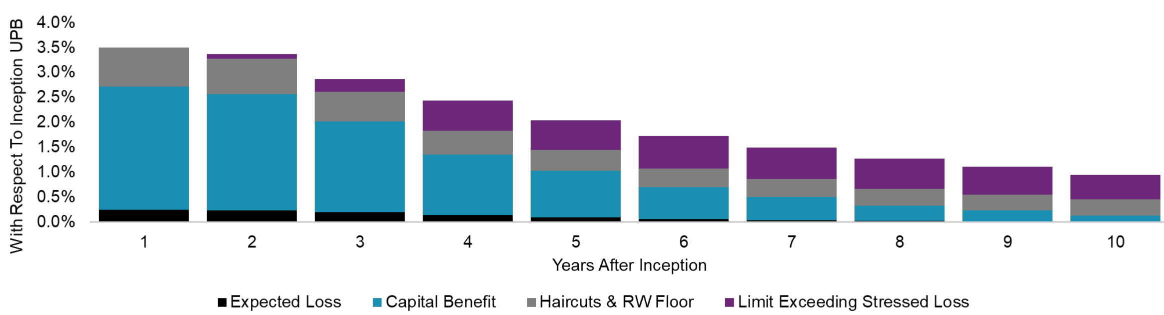
Graph 1 – Simplified RBC Capital Relief for CRT Transaction at Inception



Under ERCF, this illustrative CRT structure would receive 60 cents of RBC capital relief at the inception of the policy for every dollar of limit purchased. By eliminating the OEA and reducing the tranche risk weight floor, the capital relief improves by 33% to 80 cents per dollar of limit purchased.

Graph 2 extends the same illustrative CRT structure and compares the capital relief over the lifetime of the CRT transaction in a baseline macroeconomic scenario.

Graph 2 -- Simplified RBC Capital Relief for CRT Transaction over Time in Baseline Scenario



The graph highlights how a CRT transaction that is appropriately sized to initial ERCF stress loss can become less efficient in favorable home price scenarios over time. As the underlying loans in the CRT transaction pay off and the associated RBC capital requirement on these loans is reduced, the CRT capital benefit represented by the blue bar decreases with time. The purple bar represents CRT limit in excess of the ERCF stress loss, which builds up over time in good environments where the ERCF stress loss decreases faster than the CRT limit. The gray bar represents the impact of the CRT capital benefit haircuts and 5% tranche risk weight floor, which increases over the term of the CRT transaction. Although the tranche risk weight floor was reduced from 10% to 5%, it continues to be a relatively large and fixed amount of capital relief reduction that grows as a ratio to outstanding limit and becomes a larger drag on CRT capital benefit with time.

Overall, FHFA's proposed amendments represent a significant step in the right direction for increasing the incentives for the Enterprises to engage in CRT. We commend FHFA for suggesting these changes.

Aon's Response to FHFA's 2021 Amendments

In response to FHFA's request for comments on their 2021 Amendments, we outline potential additional changes to ERCF which we believe would enhance Enterprise safety and soundness through CRT and would encourage future innovation in the CRT program. Additionally, we would like to point to items FHFA may want to consider in their review of any further changes to ERCF.

Proposed Additional Changes to ERCF

Our proposed additional changes to ERCF are:

1. Incentivize Enterprises to purchase CRT limit beyond ERCF stress loss
2. Promote innovation in CRT structuring and design

Incentivize Enterprises to Purchase CRT Limit Beyond ERCF Stress Loss

To ensure that the Enterprises operate in a safe and sound manner and are positioned to fulfill their statutory mission, we suggest that they be incentivized to purchase CRT limit beyond the ERCF stress loss. Additional CRT further reduces the credit risk retained by the Enterprises, and subsequently by US taxpayers while the Enterprises remain in conservatorship. For example, during stress periods, the Enterprise's own loss reserve forecast or the market participant's loss projection may overshoot the ERCF stressed loss levels. Having additional CRT limit above the ERCF stressed loss serves as an extra buffer to support the orderly functioning of the mortgage market and reduce the likelihood of a systemic market crash.

Consistent with our prior suggestion in Aon's 2020 Comment, we believe that additional CRT limit should qualify for limited additional capital benefit that can reduce the RBC requirements. One simple approach could be to reduce the effective CRT capital haircut by buying additional CRT limit, but we encourage FHFA to consider other similar alternatives.

Incentivizing the Enterprises to purchase CRT limit beyond ERCF stress loss addresses one of the main motivating factors for penalizing capital relief for CRT through the tranche risk weight floor: that there is model risk and idiosyncratic risk associated with CRT structuring. By incentivizing the Enterprises to purchase additional CRT limit beyond ERCF stress loss, model risk is alleviated as there will be a reasonable amount of additional CRT to provide a credit loss risk buffer. If CRT limit is purchased beyond ERCF stress loss, we believe it warrants some reduction in the magnitude of capital relief haircuts applied to CRT.

Promote Innovation in CRT Structuring and Design

FHFA along with the Enterprises and Aon have worked closely since 2012 to establish the CRT reinsurance programs. These innovations catalyzed the evolution of the Enterprises from a buy-and-hold model to a buy-and-distribute model. Presently, FHFA maintains a rigorous but timely review and approval process for proposed enhancements and structural changes to CRT transactions or other alternative risk transfer structures. This collaborative review and approval process allows both FHFA and the Enterprises to scrutinize the efficiency and efficacy of new CRT structures while promoting further innovation.

To promote further innovation in CRT structuring and design, we suggest removing the provision mandating notice and public comment related to other CRT structures (see section IX-D.7 of the final rule). FHFA can already seek notice and public comments on certain new CRT structures if it deems beneficial but requiring notice and comment on all new CRT structures will stifle the pace of innovation.

In addition, we suggest that FHFA modifies the ERCF to explicitly allow the Enterprises to use cancellation options as a standard provision in future CRT transactions. The cancellation options that are included in existing CRT transactions provide additional flexibility to the Enterprises to manage both the ongoing cost and capital benefit of CRT transactions.

Considerations for Evaluating Additional Changes to ERCF

We further discuss some guiding principles when considering additional changes to ERCF. Due to the complexity of the capital framework, we believe that these considerations are important to ensure that different components within the capital framework will work cohesively together and to prevent any unintended consequence to CRT market.

1. Changes to individual ERCF component should be considered holistically due to complicated interactions within the capital framework.
2. Impact to CRT should be evaluated dynamically over time in addition to at the inception of transaction

Consider Any Future Changes to ERCF Holistically

The ERCF is highly complex with many interacting provisions. Any additional amendments should be evaluated holistically to understand the impact on CRT. We suggest that FHFA considers the comprehensive effects from any future changes that are made to the broader ERCF to avoid unintended consequence to the reasonable dynamics within the capital rule.

For example, the 20% loan level risk weight floor balances the overall RBC capital requirement against the overall leverage capital requirement. A decrease in the 20% risk weight floor or an increase in the leverage capital requirement may adversely affect the balance between the two capital requirements. Alternatively, with respect to CRT, the tranche risk weight floor and the OEA contribute to the overall capital effectiveness of CRT. An increase in one of these adjustments without a commensurate decrease in the other will adversely affect CRT capital relief.

Evaluate Changes to ERCF And CRT Dynamically Over Time

The Enterprises are incentivized to engage in CRT at the inception of the transaction, but those incentives reduce over time and may result in unfavorable economics over the lifetime of CRT transactions even as they continue to provide valuable credit risk protection to the Enterprises. We suggest that FHFA evaluate the impact on CRT capital benefit both at the inception and over the lifetime of CRT transactions as it considers changes to the ERCF.

For example, under the majority of economic scenarios, as mortgages season, their required capital is reduced. In such case, the fixed 5% tranche risk weight floor becomes proportionally larger to the CRT capital benefit. Furthermore, the 20% loan level risk weight floor is more likely to be binding.

Conclusion

We would like to again express our support for FHFA's stated goals for their 2021 Amendments and we believe the proposed changes are an important step in the right direction with respect to ERCF. Aon has proposed two additional changes that we believe would be straightforward to implement and would further enhance Enterprise safety and soundness, CRT capital treatment, and innovation in CRT.

We welcome your feedback and look forward to discussing this response with you. Thank you for providing us with the opportunity to participate in this discussion.

Contact Information

Joe Monaghan
Global Growth Leader
Aon Reinsurance Solutions
and CEO of Aon Public Sector Partnership

Jay Pacious
Managing Director
Aon Public Sector Partnership

Ben Walker
Senior Managing Director
Aon Reinsurance Solutions

Andreas Koutris
Managing Director
Aon Reinsurance Solutions

Jonathan Lim
Managing Director
Aon Reinsurance Solutions

Fangyu Gao
Managing Director
Aon Reinsurance Solutions

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

About Aon's Public Sector Partnership (PSP)

Aon's PSP is a global team of professionals focused exclusively on serving the unique needs of governments by creating innovative solutions for federal, state and local agencies. For over 40 years, Aon has supported public entities globally, including many Federal agencies, more than half of the U.S. states, and over a hundred large municipal governments. We are a dedicated team of colleagues with broad experience in both government and the private sector that delivers all of Aon's capabilities to help our government clients secure their public mission.

The information contained herein and the statements expressed are of a general nature and are not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information and use sources we consider reliable, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.