MBa

MORTGAGE BANKERS ASSOCIATION

November 30, 2015

The Honorable Melvin L. Watt
Director
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20024

Dear Director Watt:

FHFA has made substantial efforts to reduce taxpayer exposure to risk by requiring Fannie Mae and Freddie Mac (the GSEs) to undertake credit risk transfers (CRTs). MBA fully supports this effort and we ask that you consider a meeting with MBA and several of our lender members to discuss ideas on how to conduct these risk transfers. Given the requirements under the PSPAs to reduce the GSEs' retained capital to zero by 2018, it is imperative that the GSEs reduce their retained risk in order to avoid any increase in taxpayers' investment in the enterprises. MBA believes it is critical that FHFA incorporate more explicit up-front risk sharing targets in the 2016 scorecards.

Up-front transactions are defined as those that de-risk loans before they are acquired by the GSEs, as opposed to back-end CRTs which require the enterprises to warehouse risk for a period of time, making them subject to swings in credit spreads, and having them retain substantial risk for the life of the loans. In fact, Freddie Mac's losses in the third quarter of 2015 were attributed at least partially to widening of credit spreads.

Multiple forms of up-front risk sharing should be piloted including deeper cover mortgage insurance (MI), lender recourse, and structured finance. We focus on the MI approach in this letter because that is where MBA has heard a number of concerns expressed. At the same time, this approach would be operationally easiest for the vast majority of lenders.

MBA believes that up-front risk sharing should be approached in a manner that maximizes the opportunity for the market broadly, and should not advantage certain lenders relative to others. Approved sellers to the enterprises of all sizes and business models should be eligible to participate on an equal footing. The industry, FHFA, and the enterprises have worked for years to level the playing field between larger and smaller lenders. This effort should continue in that tradition.

Additionally, MBA strongly urges FHFA and the enterprises to be more transparent with respect to the pricing and terms of any CRTs. An important goal of these transfers is to learn more about the private market price for mortgage credit risk. Complex, opaque structures do not assist with this goal. Rather, the enterprises should make more use of simple, easily scalable approaches with transparent pricing.

Overview

The fundamental premise of up-front risk share transactions is to allow lenders to secure deeper credit enhancement on their loans in exchange for reduced g-fees and LLPAs. In addition to de-risking loans prior to their acquisition by the enterprises, this effort could also reduce the cost of credit to consumers, as indicated by the recent Milliman study[1], and undoubtedly would increase the extent of competition in the secondary market, as multiple players would bid to hold this risk as opposed to just the two enterprises.
MBA has highlighted multiple benefits of up-front, loan level risk sharing:

- Restores private capital and reduces taxpayers' risk exposure without increasing costs to borrowers, as is the case with increases in g-fees or LLPAs
- De-risks mortgages before they get on GSE balance sheets, rather than trying to sell off GSE risk through back-end deals
- Increases competition for credit risk, which could increase access to mortgage credit for homebuyers
- Disperses risk away from the enterprises
- Provides improved price discovery to help ensure g-fees reflect the market price for risk
- Increases lender ability to provide competitive pricing for borrowers through an additional, optional execution.
    - Most models of the future secondary market would mandate similar risk sharing
    - This initiative provides a "proof of concept" before the market is locked in to a new system
- Preserves TBA execution, which ensures market liquidity.
- Provides a transparent, replicable approach to risk sharing that is available to lenders of all sizes and business models.

Lender utilization of this approach would depend on the relative costs, which would be driven by MI pricing and importantly by the extent of bona fide reductions in g-fees/LLPAs granted by FHFA and the enterprises.

While we have clearly stated support for various approaches in deploying an up front risk share model, the most significant resistance has come from the discussion regarding the use of up front mortgage insurance. It is for this reason that we will focus on this subject now.

MBA Response to Objections to MIs as Deeper Counterparties

In responding to our advocacy for this approach over the past few years, the enterprises and others have raised a number of points with respect to the broader use of private mortgage insurance contemplated in this proposal.[2] These arguments seem to continuously arise so we believe it best to take them seriously and address the concerns here. Below, are a number of these assertions and provide our views.

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[1] http://www.usmi.org/wp-content/uploads/2015/10/Milliman-Report-Analysis-of-Deep-Coverage-MI-FINAL.pdf

[2] MBA has advocated that lenders should both be able to obtain deeper coverage on loans with initial LTVs above 80, and to obtain coverage on loans within initial LTVs below 80.

- *"The MI industry is mono-line and does not diversify the risk as the MIs would fail at the same time as the GSEs."*

The GSEs are also mono-line and share the same exposure. Mono-line insurers should be held to higher capital requirements than diversified insurers. In fact, the GSEs' recently-revised Private Mortgage Insurer Eligibility Requirements (PMIERs) do require higher capital levels for the MIs for precisely this reason.

However, the benefits of deeper risk sharing with respect to taxpayer protection come from the fact that the MIs have equity capital and the ability to raise additional capital resources through equity and debt issuance and through building reinsurance capacity. On the other hand, the GSEs' capital is going to zero under the PSPAs, and they are restricted from raising more. Both the GSEs and the MIs should be encouraged to distribute the risk among multiple counter parties rather than concentrating the risk on their balance sheets.

- *"The MI industry lacks adequate capital. The GSEs are AAA rated while the MIs are not even all investment grade. How could transferring risk to a lower-rated counterparty make sense?"*

As the rating agencies make clear, the GSEs have a rating that is solely the result of the US Treasury backstop.[3] Removing the backstop would result in a much lower rating for the GSEs. The MI industry has more loss absorbing capacity than the GSEs do, and hence it makes sense to transfer the risk.[4]

With respect to MI ratings, the PMIERs explicitly do not rely upon financial ratings. The prior set of eligibility standards were ratings based, while the PMIERs were designed as a much more sophisticated and comprehensive view of MI financial and operational capacity.

The government backstop which provides the AAA rating on the MBS needs to be retained to ensure liquidity in the market. The risk in front of the government should be distributed amongst multiple private entities that have sufficient capital to hold or manage this risk. The taxpayers, with the GSEs acting as their agent, guarantee the loan regardless of front end or back end – structured or loan level.

The MIs should be encouraged to further build their capital base, in addition to making even more use of reinsurance and engaging in structured credit trading themselves to augment their capital needs. This would lead to greater distribution of risk, rather than concentration, while utilizing an approach -- primary MI at the loan-level at point of sale – which every lender in the country can participate in, as it is already part of their daily operations.

The new financial standards that are a major component of the PMIERs' eligibility standards for mortgage insurance covering loans purchased or guaranteed by Freddie Mac or Fannie Mae were published jointly by Freddie Mac and Fannie Mae with FHFA oversight. These operational

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[3] *Moody's Disclosures on Credit Rating of Federal National Mortgage Association*, https://www.moodys.com/research/Moodys-Disclosures-on-Credit-Rating-of-Federal-National-Mortgage-Association--PR_243868

[4] This has also been the case historically. In 2001, S&P asserted that the MIs had more financial strength than the GSEs did on a standalone basis. See "Standard & Poor's New Risk-based Capital Model for U.S. Residential Mortgage Insurers", September 2001.

standards lay out the criteria for underwriting of loans and lenders, master policy terms and conditions, and claims settlement procedures and timelines. This multi-year effort resulted in a substantial upgrading of the financial strength of the MIs, who are clearly already important counterparties to the GSEs.

The PMIERs were developed to ensure a stronger MI industry. There is no reason to not move forward given the higher degree of confidence in their financial strength.

- *"The PMIERs are only a minimum standard for operating as an MI and not one that creates enough capital for all the MIs to withstand a deep downturn."*

The capital held by MIs on a leveraged basis is deeper than that held currently by the GSEs. Trading this risk to MIs is preferable to the GSEs needing to draw from a Treasury line. The new capital requirement has significantly reduced the leverage of the MIs and increased their capital. Risk-to-capital ratios have decreased from 25:1 to 14:1. These levels were designed so that the MIs could withstand a very deep recession comparable to the 2007-2008 crisis.

If the level is not acceptable, FHFA could establish a reasonable standard above the PMIERs minimum that would be required for an MI to participate in up-front risk sharing.

- *"The MI industry didn't pay claims."*

Lenders and the GSEs were concerned about the use of rescissions to reduce claims paid on legacy business. Lenders are also keenly aware that these rescissions triggered repurchase demands from the GSEs, adding to lender's losses.

Just as the GSEs improved their representation and warranty framework, the MBA believes that substantial progress has been made with respect to the MIs' "clarity of coverage" through the new master policy agreements. The FHFA and the GSEs have implemented requirements that include assurance of coverage, such that loans that make 12 timely payments for loans with independent verification are not candidates for rescissions of claims.

The MIs that failed through the crisis and are currently in runoff continue to pay on claims, and evidence from their financial statements indicates that the vast majority of claims will be ultimately paid. Thus, the extent of counterparty risk may be overstated.

Some have also suggested obligating MIs to pay all claims the same way that the GSEs do, and determining ultimate liability after the fact. For the purposes of advancing this proposal, further strengthening the commitment to pay claims may well be the right approach if the paradigm will shift to having MIs become the primary credit guarantor. Under this proposal, the GSEs still have an important role to play, so that step may not be appropriate at this time.

- *"CRTs that post cash up front are necessarily safer than relying upon counterparties."*

The GSE model today leaves all ultimate risk with the taxpayer, as the GSEs have little capacity to absorb that risk. Backend CRTs are innovative technologies that could be used by lenders, MIs, and others to distribute risk.

As used by the enterprises, however, they still lead to a concentration of risk as the GSEs still need to warehouse and then attempt to distribute accumulated risk. The STACR and CAS structures leave substantial basis risk volatility on the GSEs' balance sheets and can result in ongoing earnings risk with far greater swings than the up-front MI risk share.

Perhaps more importantly, it is not clear that STACR and CAS will always be available as a viable economic execution through the business cycle. As FHFA has highlighted, it is very important for the GSEs to fully develop a range of techniques to distribute risk, to avoid being forced to hold the risk through a market downturn.

The enterprises are well positioned given their quasi-regulatory role with respect to the MIs to diligently manage their counterparty exposure going forward. The enterprises monitor incoming business, as well as set loan and lender level criteria for the MIs through PMIERs and the GSEs' own credit criteria. Moreover, the enterprises maintain substantial negotiating leverage with respect to their ability to limit or expand future business from MIs. All of these factors indicate that the enterprises have more than ample ability to manage this counterparty risk.

- *"The MIs cherry pick and won't support affordable goals."*

Until this point, the MIs have been entirely focused on low downpayment lending serving first-time homebuyers. Average LTVs on MI business are significantly higher, and average credit scores are somewhat lower than those for the full GSE market. This business lines up naturally with the enterprises' affordable programs and initiatives.

Beyond the natural fit, the enterprises could set standards with MIs to support their affordable programs should they rapidly grow deeper coverage.

- *"The GSEs are required to pay MBS investors in a timely manner regardless of whether borrowers pay. MIs do not reimburse the GSEs until later in the process. "*

This is a true statement, but does not represent a significant hurdle to moving forward with this proposal. The GSEs have the need to reconcile cash flows with different timings across various aspects of their business, and could certainly do the same here.

Conclusion

In summary, MBA believes that up-front, loan-level risk sharing, pursued in a manner that would maintain a level playing field for lenders of all sizes, particularly through greater use of private mortgage insurance, would reduce taxpayer exposure to mortgage risk, and that the enterprises are well placed to manage any residual counterparty risk given the new master policies and the PMIERs standards which were just finalized. Moreover, multiple forms of up-front risk sharing should be piloted, including not only deeper cover MI, but also greater use of lender recourse. FHFA should require the use of transparent secondary market pricing that is available to all approved lenders.

We urge FHFA to require the enterprises to move a meaningful extent of their mortgage credit risk to up-front transactions that are transparent, replicable and available to lenders of all sizes. In alignment with FHFA's goals, this effort reduces taxpayer risk, maintains a liquid and dynamic market, and helps to build towards the new system by increasing the amount of private capital in front of the enterprises and their federal backstop.

Finally, a large portion of this document concerns MIs. We wanted to stress that we don't view MI as the sole solution to meet the demands of up-front risk share. However we felt the need to acknowledge the importance of MIs in this equation given all of the expressed concerns MBA has heard.

We look forward to meeting with you in the near future.

Sincerely,

David H. Stevens, CMB
President and Chief Executive Officer

cc: Bob Ryan
Megan Moore
Eric Stein