USMI
U.S. Mortgage Insurers

October 11, 2016

BY ELECTRONIC SUBMISSION

Federal Housing Finance Agency
Office of Financial Analysis and Modeling
Constitution Center
400 7th Street, S.W., 9th Floor
Washington, D.C. 20219

Re: Single-Family Credit Risk Transfer Request for Input

Ladies and Gentlemen:

U.S. Mortgage Insurers ("USMI")[1] welcomes the opportunity to submit this response to the request for input ("RFI") from the Federal Housing Finance Agency ("FHFA") regarding the single-family credit risk transfer ("CRT") activities of the Federal Home Loan Mortgage Corporation ("Freddie Mac") and Federal National Mortgage Association ("Fannie Mae") (collectively, the "Enterprises").

The RFI is intended to foster a discussion of principles for evaluating forms of CRT and to explore possibilities for expanding the proportional use of "front-end" CRT – *i.e.*, transactions in which private market participants retain or assume credit risk on mortgages before or at the same time the Enterprises acquire and guarantee such mortgages. Conversely, with "back-end" CRT the Enterprises fully assume credit risk at the time the mortgages are acquired or guaranteed, and then transfer all or a part of that risk at a later time. To date, over 98% of the Enterprises' CRT activities have consisted of back-end CRT.[2]

An expansion of front-end CRT warrants serious consideration by FHFA as a complement to existing back-end CRT because, without front-end CRT, the Enterprises' CRT strategy would not function adequately during all phases of the mortgage credit cycle, particularly during times of financial stress, and therefore would not fully realize FHFA's principal objective of protecting U.S. taxpayers. That is, the optimal CRT strategy must have "through the cycle" functionality that allows the Enterprises to effectively transfer credit risk

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[1] USMI is a trade association composed of the following private mortgage insurance companies: Arch Mortgage Insurance Company, Essent Guaranty, Inc., Genworth Financial, Mortgage Guaranty Insurance Corporation, National Mortgage Insurance Corporation, and Radian Guaranty Inc.

[2] *See* Federal Housing Finance Agency, Single-Family Credit Risk Transfer Progress Report (June 2016). This figure is based on FHFA's use of the term "CRT," excluding mortgage insurance and other forms of CRT implemented by the Enterprises prior to 2013 in order to comply with the terms of the Enterprises' statutory charters. *See* Federal Housing Finance Agency, Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions, p. 3 n.2 (Aug. 2015).

during turbulent market periods. Front-end CRT achieves that objective because it allows the Enterprises to avoid assuming a significant amount of first-loss credit risk that they may not be able to transfer during a down period in the mortgage credit cycle.

In addition, front-end CRT directly involves important primary market stakeholders such as lenders in the risk transfer process. For example, front-end CRT that takes the form of private mortgage insurance ("MI") has the distinct advantage of being inclusive and scalable for originators and servicers of all types and sizes, including, for example, community banks, credit unions, and other smaller mortgage originators, using processes and techniques already familiar to those stakeholders. MI can also provide expanded homeownership opportunities to creditworthy homebuyers who do not have the resources for a large down payment, a benefit that is less likely to result from back-end CRT.

Indeed, USMI strongly believes that significantly increasing the proportion of front-end CRT in the Enterprises' CRT strategy will advance four key objectives of a well functioning housing finance system by ensuring that: (1) a substantial measure of private capital loss protection is available in bad times as well as good; (2) such private capital absorbs and deepens protection against first losses before the government and taxpayers; (3) all sizes and types of financial institutions have equitable access to CRT; and (4) CRT costs are transparent, thereby enhancing borrower access to affordable mortgage credit.

Based on key evaluation criteria, Chart 1 below demonstrates the key advantages of one form of front-end CRT, deeper MI, versus several forms of back-end and front-end CRT. "Deeper MI" is the use of substantial amounts of MI for loss protection both on (1) loans above the 80% loan-to-value ("LTV") threshold commonly associated with MI, and which without such deeper cover MI would typically have a lower level of MI; and (2) loans below the 80% LTV threshold, whether or not already subject to MI coverage.

Chart 1: CRT Evaluation Criteria

Risk Transfer Type	**Stability:** Is the form of CRT available at stable pricing through all economic cycles?	**Timing**: Is credit risk absorbed as part of the form of CRT before loans are purchased by the Enterprise?	**Access**: Do large and small lenders have systems, processes, and resources to use the form of CRT?	**Transparency**: Is the cost of the form of CRT published, and is there a direct link to the borrower cost?
STACR / CAS Credit Linked Notes Senior-Sub (Back-end CRT)	-	-	-	-
CIRT / ACIS (Back-end CRT)	-	-	-	-
Collateralized Recourse (Front-end CRT)	-	+	-	-
Deeper MI (Front-end CRT)	+	+	+	+

MI's principal benefits as a form of CRT (which are described in detail in the appendix to this letter responding to the RFI's specific questions) are summarized below:

- **Increased CRT availability and market stability**. For CRT to have real value, it must be a ***reliable*** source of loss absorption when needed, ahead of the Enterprises and taxpayers, and it must be consistently ***available*** as a form of risk transfer, including during volatile mortgage credit markets. The reliability of a form of CRT in providing loss absorption can be enhanced through structural mechanisms such as collateral, segregated accounts, asset requirements, and counterparty financial and operational reviews. The availability, on the other hand, is not as readily enhanced, especially where the CRT is provided in the form of structured transactions that depend on market receptivity at particular points in time. In contrast, CRT is likely to be more consistently available when provided by going concerns that are focused on mortgages, have a long-term interest in CRT, and depend on their reputation as reliable counterparties in the housing industry. Mortgage insurers have such a long-term, reputational interest. They are dedicated exclusively to providing credit loss protection on residential mortgages, most commonly on a loan-level basis upon origination, and they specialize in residential mortgage credit risk. Expanding the proportional use of MI-based CRT will enhance the overall availability of CRT to the Enterprises and therefore contribute significantly to market stability.

- **Reduced first-loss holding risk**. Historically, the Enterprises have held all credit risk related to the mortgages they guarantee, except for the risk transferred prior to loan acquisition, typically through MI on higher LTV loans. A comprehensive CRT strategy should not involve the Enterprises continuing to hold on to such a large amount of credit risk until back-end CRT transactions can be completed; when mortgage stress intervenes, such transactions may never materialize on economically sensible terms, and as a result, the credit risk will remain with the Enterprises and U.S. taxpayers. Front-end CRT like MI squarely addresses this concern by transferring credit risk ***before*** the Enterprises acquire and guarantee each loan.

- **Beneficial stakeholder familiarity and equitable access**. Novelty and innovation are helpful for stimulating and enlarging the available forms of CRT, but the Enterprises should not rely disproportionately on forms of CRT that are untested in times of market volatility and are unfamiliar to housing market stakeholders. Such newer forms of CRT entail increased legal risk because their documentation and processes may have not been interpreted or arbitrated during a financial crisis, when the timely payment of funds due is critical. In contrast, MI is known, tested, scalable, and used by a variety of stakeholders on an equal basis. It also preserves the important segregation of primary market participants such as lenders and mortgage insurers, and secondary mortgage participants such as the Enterprises.[3]

[3] Certain commentators have suggested that expanded use of MI will produce disproportionate benefits to larger lenders to the extent that such lenders are able to negotiate more profitable rates with respect to "lender-paid" MI and that these benefits are a reason to avoid expanded MI-based CRT altogether. "Lender-paid" MI is paid directly by the lender, is not subject to cancellation under the Homeowners Protection Act, 12 U.S.C. §§ 4901 *et seq.*, and may be a longer-lasting form of CRT than "borrower-paid" MI, in which the insurance premiums are paid by the borrower but are subject to cancellation. In response to

- **Increased transparency**. FHFA and the Enterprises have made commendable efforts to increase the amount of information available regarding loans subject to back-end CRT arrangements. Front-end CRT such as MI has the additional advantage of establishing value and pricing in advance so that lenders can determine whether to make use of such CRT on a prospective basis, fostering competition among CRT providers to the benefit of borrowers who may be funding all or part of the CRT. In turn, this increased transparency facilitates the creation of quantitative and qualitative standards for comparing front-end CRT[4] -- and greater transparency enables more efficient monitoring of financial stability concerns regarding the Enterprises and their CRT programs.

USMI strongly believes that the foregoing benefits of MI are clear and demonstrable, and are not offset by two concerns raised in the RFI: "reimbursement" risk (*i.e*., the risk that a mortgage insurer will not provide promised funds to the Enterprises when required to absorb losses), and "concentration" risk (*i.e*., the potential for disproportional exposure by the Enterprises to mortgage insurers).

In terms of the first concern, mortgage insurers are subject to the Enterprises' Private Mortgage Insurance Eligibility Requirements ("PMIERs"), which are detailed operational standards that an insurer is required to satisfy in order to conduct business with the Enterprises.[5] The PMIERs are designed to ensure that insurers have rigorous risk management and sufficient capital and liquidity to pay claims in adverse financial markets. In addition, the reimbursement risk arising from MI is substantially less than the credit risk the Enterprises avoid assuming.[6]

In terms of the second concern, the concentration risk arising from MI is also overstated. The Enterprises' exposure to mortgage insurers – which comprise a number of different companies – constitutes only 15% of their total exposure to all counterparties, which is less than the Enterprises' STACR/CAS-related exposure. Chart 2 below illustrates this exposure. USMI believes that this measured amount of existing proportional exposure to a range of

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these commentators, state insurance premium rate regulation is a complex but public and transparent process. Negotiations of MI rates would occur in a transparent manner based on the interests of all lenders. Respected analysts who have examined the issue have concluded it is manageable and is not a reason to avoid exploring use of front-end CRT involving MI. *See* Laurie Goodman, Jim Parrott, Ellen Seidman, and Mark Zandi, How to Improve Fannie and Freddie's Risk Sharing Effort (Aug. 2016).

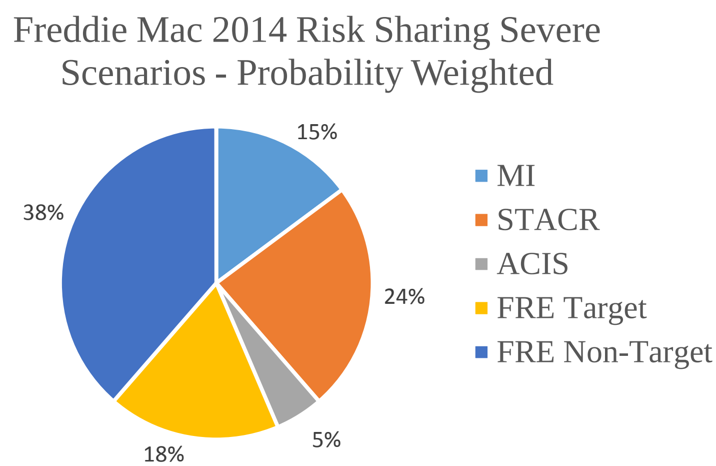
[4] FHFA has provided useful descriptions of the various risks associated with CRT in the RFI and elsewhere. However, quantification of those risks to enable comparison of risks and prioritization of risk mitigants is essential to developing a robust and comprehensive approach to the Enterprises' CRT programs.

[5] *See* Fannie Mae, Private Mortgage Insurer Eligibility Requirements (Dec. 21, 2015), *available at* https://www.fanniemae.com/content/eligibility_information/private-mortgage-insurer-eligibility-requirements.pdf, Freddie Mac, Private Mortgage Insurer Eligibility Requirements (Dec. 21, 2015), *available at* http://www.freddiemac.com/singlefamily/pdf/PMIERs.pdf. The PMIERs are complemented by the updated MI Master Policy developed in conjunction with FHFA and Enterprises, which was revised to improve clarity regarding policy disputes that sometimes led to coverage rescissions under the prior version.

[6] *See* Steve Mackey and Ted Durant, *Making a Case for Deep Cover Mortgage Insurance*, Journal of Structured Finance, vol. 22 (Spring 2016) (concluding that deep cover mortgage insurance on a hypothetical loan would reduce risk to the Enterprises by 130 bps while the incremental counterparty risk assumed by the Enterprises with respect to such loan would be only 1.2 basis points), *available at* http://www.iijournals.com/doi/pdfplus/10.3905/jsf.2016.22.1.056.

different mortgage insurers clearly leaves room for increased exposure through deeper MI, especially in light of the fact that the ongoing strength of these companies as counterparties has been substantially enhanced by the financial, risk management, and operational standards required by the PMIERs. Moreover, the concern about potentially excessive exposure overlooks the facts that credit risk is transferred to specific counterparties and not to the MI industry collectively and that mortgage insurers have the ability to engage in CRT transactions themselves that would effectively reduce the Enterprises' risk exposure.

Chart 2: Allocation of Projected Losses to Freddie Mac Based on CRT in Place as of 2014[7]



MI provides other advantages as well. Unlike the Enterprises' CIRT/ACIS programs, which are also "entity-based," MI provides loan-level credit enhancement purchased at origination on transparent terms before or at the same time that the Enterprises purchase or guarantee the loan. This provides an effective form of credit risk mitigation at the very beginning of the loan origination process. Further, mortgage insurers are sources of countercyclical, entity-based private capital that are dedicated to the housing market and subject to both federal and state regulation. This distinguishes mortgage insurers from other entity-based forms of risk transfer, including other credit insurers that do not maintain contingency reserves and may be domiciled in tax-advantaged jurisdictions.

One additional function served by the RFI's analysis of CRT principles and exploration of front-end CRT is that it **<u>facilitates discussions regarding housing finance reform</u>**. USMI believes that FHFA's adoption of principles to govern front-end and back-end forms of CRT has the potential to provide coherence and consistency regarding the long-term use of CRT. This foundation is helpful for housing finance reform discussions. Front-end CRT preserves or enhances reform alternatives by demonstrating that credit risk can be transferred on stable terms prior to or at the time of a loan's acquisition and guarantee by the Enterprises. The success of such an approach over time will enhance confidence in broader reform proposals that, like front-end CRT, do not rely so heavily on preservation of the existing role of the Enterprises

[7] *See* Andrew Davidson, Credit Risk Transfer: Making a Successful Program Even Better (Feb. 2016).

as credit risk holders and aggregators. However, if the Enterprises continue to disproportionately pursue back-end CRT programs, discussions regarding housing finance reform will proceed with far less flexibility because of the need for the Enterprises to exist in their current form to make such programs work.

In short, for the reasons described above, USMI believes that FHFA and the Enterprises should significantly expand the proportional use of MI to achieve effective CRT, both on loans with LTV ratios exceeding 80% LTV that are commonly associated with MI, as well as on loans with LTV ratios below that threshold.

Against this background, attached to this letter are USMI's detailed responses to the questions in the RFI, which describe our consideration of the Enterprises' CRT efforts to date; the utility of FHFA's proposed principles and assessments of risks; the policy rationale for a more balanced CRT approach that includes greater proportional use of front-end CRT, especially through deeper MI; and more contextual information regarding mortgage insurers.

Questions or requests for further information should be directed to Lindsey Johnson, President and Executive Director of USMI, at ljohnson@usmi.org or (202) 280-1820.

Sincerely,

U.S. Mortgage Insurers

U.S. Mortgage Insurers
Federal Housing Finance Agency Request for Input on Credit Risk Transfer
Responses to Specific Questions

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

USMI has comments on both principles and risks. With regard to the former, we support the articulation of principles that will guide the Enterprises' CRT programs, with three recommendations, one of which calls for the adoption of additional principles.

First, it is unclear whether and to what extent the CRT principles will be applied to back-end CRT activities that are already occurring. For example, the CAS and STACR credit-linked debt issuance programs established by the Enterprises have experienced price volatility under non-stressed economic conditions and have not undergone either a full economic or housing market cycle. Yet, CAS and STACR issuances continue to increase,[8] and it is unclear whether they will be evaluated in accordance with the principles in the RFI, and if so whether their use could be curtailed as a result. USMI recommends that the RFI principles should apply to both existing and proposed CRT activities.

Second, we recommend that the principles be prioritized and translated into quantitative standards wherever possible. In particular, the principles should be prioritized in a manner consistent with FHFA's dual mandate as the conservator and regulator of the Enterprises – *i.e.*, they should take into account both safety and soundness and broader economic and housing finance policy concerns.

Third, the following additional principles should also be taken into account in establishing the CRT framework:

- *Comparability of Counterparty Standards* – Comparable, publicly available standards should be established for all of the Enterprises' CRT counterparties in order to identify, measure, and manage counterparty and related risks on a comparable basis. This effort may involve analyzing and addressing the following: differences between capital and collateral standards; the extent to which CRT activity represents a material expansion of a current business relationship with the Enterprises (*e.g.*, collateralized recourse with seller-servicers); market and legal risks associated with purchasers of credit-linked debt issued by the Enterprises; and the extent to which rating agency criteria have appropriately been substituted for Enterprise evaluation of a counterparty's financial strength, especially where the counterparty is not primarily regulated by a federal or state prudential regulator.

[8] *See* Freddie Mac, Freddie Mac Prices $739 Million STACR Offering (Sept. 26, 2016).

- *Financial Stability* – A financial stability principle should be adopted by FHFA to ensure consistency with U.S. and global financial regulatory policy. Financial stability has been and continues to be the predominant concern for U.S. financial regulators and their global counterparts. The Enterprises are a material component of one of the largest and most liquid securities markets. The Enterprises should therefore evaluate the potential volume and complexity of CRT approaches for their potential to create financial instability, not simply to ensure that the Enterprises are reimbursed promptly. Indeed, the recent report on merchant banking[9] is a timely reminder that "diversification" should not be embraced uncritically.

- *Industry Input* – Historically, the primary and secondary mortgage markets have been closely linked but segregated. The thoughtful questions asked by FHFA regarding the desired effect of CRT on guarantee fee pricing have operational and other policy dimensions as CRT activities expand and become more complex. The Enterprises were never intended to become vertically integrated entities, and implementation of robust CRT programs by the Enterprises should not have the practical effect of dulling the bright line between primary and secondary mortgage markets. The routine practice by FHFA and the Enterprises of soliciting and incorporating input from the housing industry, including counterparties that will be involved in CRT programs, is an important check on the overall CRT process that needs to be maintained.

- *Borrower Impact* – The Enterprises were established to facilitate the ability of borrowers to obtain economical mortgage financing and build wealth through homeownership. The Enterprises' current role in aggregating credit risk – and the emerging role of distributing that risk – affects borrowers, so the tasks of understanding, explaining, and assessing those effects are critical. Just as industry input is important to ensure the integrity of the U.S. residential mortgage market, the impact of CRT activities on borrowers should be acknowledged as a core principle by FHFA to ensure that the Enterprises' mission remains centered on borrowers, sustainable homeownership, and wealth accumulation.

- *Facilitation of Housing Finance Reform* – Many policymakers have embraced the goal of future housing finance reform, which could very well include changes to the role of the Enterprises. The Enterprises' CRT activities should be assessed in this context. That is, FHFA and the Enterprises should implement CRT programs that facilitate, or at least do not obstruct, measures such as termination of the Enterprises' conservatorships and the transition to a different role for the Enterprises. At a minimum, FHFA should consider and explain how CRT approaches preserve or enhance options for housing finance reform. For example, a CRT approach that emphasizes Enterprise aggregation of credit risk and distribution of that credit risk through long-term contracts requiring substantial monitoring may not be consistent with housing finance reform alternatives that change the role of the Enterprises to more of a liquidity provider like Ginnie Mae.

[9] *See* Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act, p. 30 (Sept. 2016).

We now comment about the risks of CRT set forth in the RFI, followed by recommendations regarding additional risks that ought to be taken into account.

First, the RFI does not specify how the Enterprises will analyze risks in order to compare different forms of CRT and ultimately prioritize the implementation of particular types of CRT. Similar to other CRT comparisons such as the Urban Institute's matrix for grading forms of CRT (see Chart 3 on page 18), USMI strongly recommends development of an analytical framework to assess the relative effectiveness of the various types of CRT structures.

Second, we respectfully disagree with the RFI statement that "a key objective in structuring credit risk transfer transactions is to minimize or eliminate this risk entirely." Instead of seeking outright to minimize or eliminate a category of risk, FHFA should quantify and compare all risk categories and make determinations based on this comparison. In addition, the RFI incorrectly characterizes rescissions and curtailments as contributors to reimbursement risk. Rescissions are a failure of the loan originator to properly secure insurance coverage. Curtailments result from either a miscalculation of the claim or a failure of the servicer to abide by delinquent servicing and claim filing requirements. As such, they constitute operational risk to the Enterprises, rather than reimbursement risk. Mortgage insurers, the Enterprises, and FHFA have made substantial changes to MI master policy terms that, combined with similar changes to seller/servicer agreements, have substantially increased the transparency of requirements and certainty of coverage.

In addition to these two comments, USMI believes that the Enterprises should take into account the following risks not described in the RFI:

- *Cyclicality* – The Enterprises should carefully scrutinize CRT programs that have not been tested during a housing downturn and avoid placing undue reliance on such programs. The reduced availability of such programs during a downturn could well lead to decreased mortgage availability to the extent such programs are not replaced with more reliable forms of CRT. In this regard, mortgage insurers have a long history of providing MI during times of housing market stress, including during the recent financial crisis. They can do this because MI, unlike CRT structures that do not have operating entities standing behind them, is provided by mortgage insurers that have as their sole business and purpose the assumption of mortgage default risk in all market conditions.

- *Supplemental credit review* – Certain forms of CRT, such as MI, involve a third party reviewing the credit policies and decisions of mortgage lenders seeking to sell certain types of mortgage loans to the Enterprises. These forms of CRT reduce credit risk to the Enterprises by overlaying a third-party review on the Enterprises' credit evaluation function.

Question A2: *How would proposed front-end credit risk transfer structures meet and balance the principles outlined in Section II and address the risks outlined in Section III?*

Front-end CRT programs that use operating entities, such as mortgage insurers, are fully consistent with the principles in the RFI:

- *Reduce taxpayer risk* – Loan-level, entity-based CRT programs such as MI are a particularly effective way to reduce taxpayer risk because they occur before or at the same time a loan is acquired or guaranteed by the Enterprise. Use of MI is very favorable in terms of the net amount of risk mitigated because the magnitude of credit risk avoided is substantially greater than the magnitude of reimbursement risk generated.[10] Deeper MI would reduce the risk to U.S. taxpayers in an even greater amount – *i.e.*, by some analysts' estimation, deeper MI could provide for an additional $18.5 billion of additional risk transferred away from the Enterprises and U.S. taxpayers.[11]

- *Continuity of core business* – Deeper MI is an extension of a current business process used by the Enterprises' customers, and thus will be compatible with the continuity of the Enterprises' core business – *i.e.*, the acquisition and securitization of mortgage loans and the guarantee of MBS – and will not adversely affect the TBA market. Indeed, MI expands borrowers' access to mortgage credit and therefore furthers the Enterprises' core business by expanding the population of loans that may be acquired by the Enterprises.

- *Repeatable and scalable* – MI has been an important form of CRT for nearly 60 years in the U.S. residential mortgage market, and thus it is familiar, repeatable, and scalable. Indeed, MI works just as well for start-up and smaller lenders as experienced or larger lenders. MI transaction documents and processes are tested and may be adjusted promptly. MI does not require the use of untested transactional documents, opaque structures, or non-GAAP accounting disclosures like some of the back-end CRT transactions already in use.

- *Counterparty strength* – As FHFA's proposed principles acknowledge, an assessment of counterparty risk includes the counterparty's ability and willingness to pay and whether the counterparty provides economical and predictable pricing and capacity in all markets. Mortgage insurers have three unique advantages as counterparties:

  First, MI as a risk management technique was developed as a response to the Great Depression, much like Fannie Mae, the Federal Home Loan Bank system, and the FHA. Early proponents of specialized entities like mortgage insurers and the Enterprises valued the simplicity and transparency of such entities and assumed their unique risks (*e.g.*, concentration risk) could be managed, including through the development of bespoke laws

[10] *See* Steve Mackey and Ted Durant, *Making a Case for Deep Cover Mortgage Insurance*, Journal of Structured Finance, vol. 22 (Spring 2016), *available at* http://www.iijournals.com/doi/pdfplus/10.3905/jsf.2016.22.1.056.

[11] *See* Compass Point Research & Trading LLC, RFI Opens Door for Deep MI Proposals, but Policy Concerns Remain (June 30, 2016).

and regulatory frameworks.[12] While mortgage insurers, like all mortgage market participants, sustained substantial losses in the recent financial crisis, their emphasis on specialization and transparency has allowed them to withstand numerous regional housing downturns of varying severity.

Second, mortgage insurers have enjoyed a long-term relationship with the Enterprises. The importance of this relationship from both commercial and reputational perspectives has incentivized mortgage insurers to perform their fundamental CRT role even under stressful circumstances. It is unclear whether other, less mortgage-focused counterparties would have acted similarly if they had more profitable non-mortgage opportunities available to them.

Third, unlike other CRT counterparties, mortgage insurers are required by the Enterprises to satisfy substantial transparency, risk management, and financial strength standards through the PMIERs. In addition, mortgage insurers have enhanced their financial strength post-crisis and reengineered their claims payment processes to make them more streamlined, efficient, predictable, and reliable. Indeed, FHFA expressly recognized in its recent annual report on guarantee fees that the final PMIERs have resulted in reduced MI counterparty exposure.[13]

In summary, counterparty strength is an advantage, not a weakness, for the Enterprises in front-end CRT activities involving MI.

- *Stability through economic and housing cycles* – No form of CRT is impervious to cyclical pressures, but MI has demonstrated the ability through economic and housing cycles to remain a steady source of credit enhancement for loans purchased and guaranteed by the Enterprises. A comprehensive CRT approach should therefore include a reliable foundation of capital from mortgage insurers. Despite the substantial losses sustained during the recent housing crisis, most mortgage insurers did not cease insurance originations or paying claims. Further, the entry of new market entrants during the crisis as other participants were exiting demonstrates the vitality of the MI business model. More broadly, USMI believes that entity-based CRT such as MI has two advantages when compared to structure-based CRT in the context of economic and housing cycles: reimbursement and capacity.

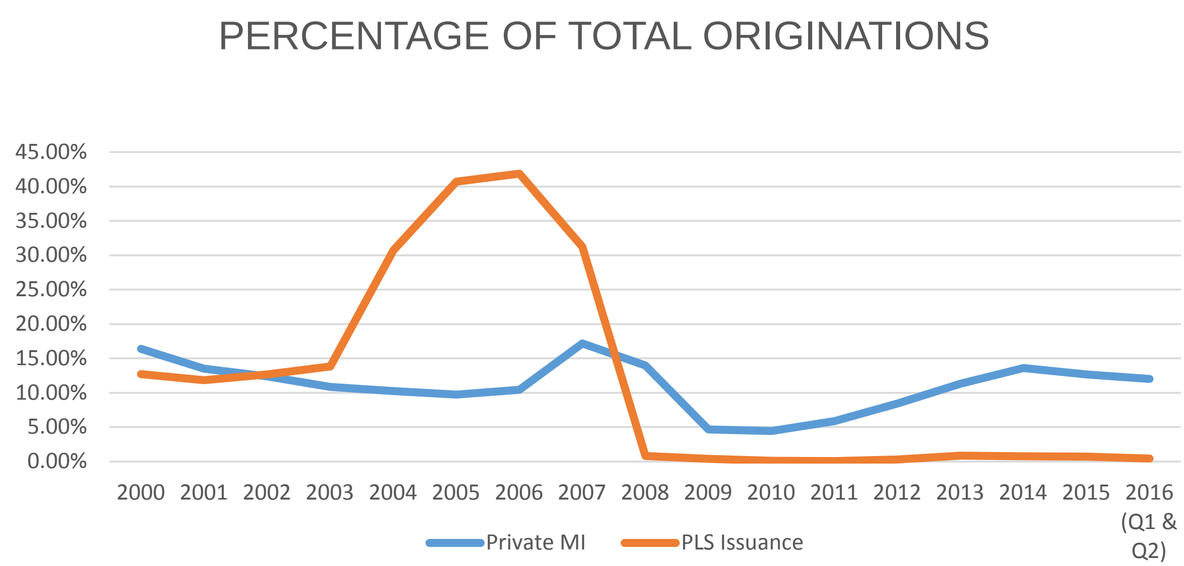
  Regarding reimbursement, although entity-based CRT creates counterparty risk for the Enterprises, operating entities such as mortgage insurers have the ability to respond to financial stress by raising additional capital in the equity, debt, and reinsurance markets, as demonstrated during the recent downturn. The ability to increase capital in stressed market conditions is a material offset to counterparty risk that is not mentioned in the RFI.

[12] *See, e.g.*, National Association of Insurance Commissioners' (NAIC) Mortgage Guaranty Insurance Model Act, *available at* http://www.naic.org/store/free/MDL-630.pdf.; *see* Dwight Jaffee, The U.S. Subprime Mortgage Crisis: Issues Raised and Lessons Learned, Presentation at the Workshop on Fiscal and Monetary Policies and Growth, World Bank Commission on Growth and Development (Apr. 11, 2008), *available at* http://siteresources.worldbank.org/EXTPREMNET/Resources/489960-1338997241035/Growth_Commission_Workshops_Fiscal_Monetary_Policies_Jaffee_Presentation.pdf.

[13] *See* Federal Housing Finance Agency, Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2015, p. 7 (Aug. 2016).

Regarding capacity, the permanent capital of entities that provide forms of CRT such as MI is a reliable source of loss absorption because it is difficult to redeploy – especially if, as is the case with mortgage insurers, PMIERs and state insurance regimes restrict the reduction of capital through the payment of dividends. The housing policy response to the U.S. residential mortgage market downturn was complex and multifaceted. For example, the Enterprises and mortgage insurers revised terms and raised prices, which had the effect of redirecting volumes to government facilities such as FHA and GNMA. However, Chart 1 illustrates the relative response of private capital to the housing crisis: private label MBS investors withdrew from the market and have not returned. This result confirms that some forms of private capital can be redeployed easily to more profitable activities during a housing downturn, making them an unreliable source of CRT during such periods of stress. MI activity, on the other hand, has returned to pre-crisis levels.

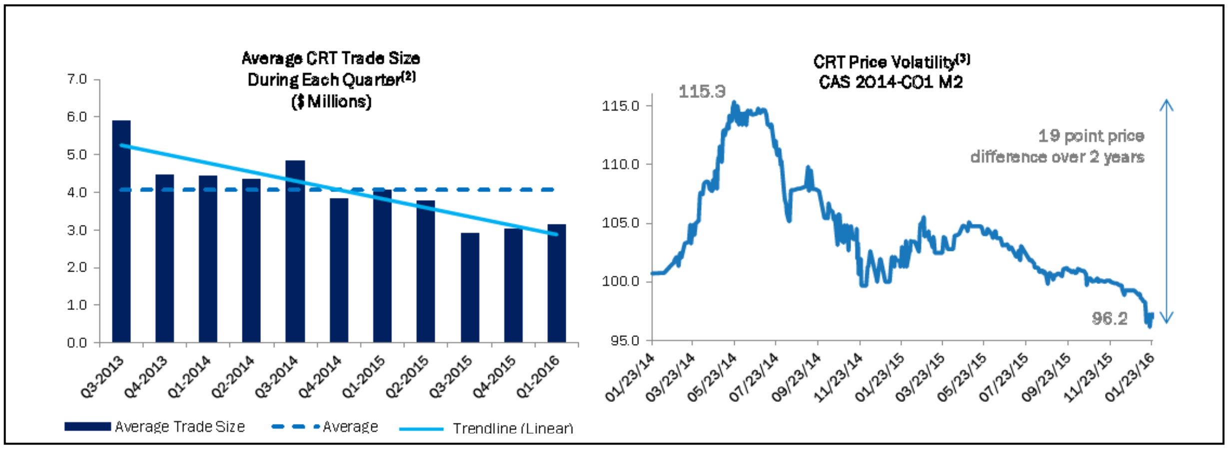
Chart 1: Private Label MBS versus Private Mortgage Insurance



Source: Inside Mortgage Finance

Stressed or crisis-like conditions are not the only factors that can cause price volatility in structure-based forms of CRT. Chart 2 shows that CAS and STACR pricing has been volatile even in recent, non-stressed conditions. This volatility can be expected to increase over time as volumes increase.

Chart 2: CAS/STACR Liquidity & Volatility



See Two Harbors Investment Corp., Credit Risk Transfer (Feb. 10, 2016).

- *Transparency* – The twin pillars of insurance regulation are consumer protection and insurer solvency. For this reason, insurance regulation emphasizes transparency, especially where coverage applies to loans of individuals. Indeed, regulators require an insurer to publish and substantiate its proposed insurance premium rates, a process that helps ensure that the insurer is neither over- nor under-charging for risk protection. Moreover, MI "rate cards" are standardized and published, and even non-standard rates are discoverable in the form of securities filings and other reports that are publicly available to lenders, borrowers, and other industry participants. More important, rate filing processes provide a mechanism for stakeholder input. Taken as a whole, the robust MI transparency facilitates strong competition among mortgage insurers and allows the public, FHFA, and the Enterprises to evaluate MI-based CRT activities. Indeed, consistent with our previous suggestion regarding the need for comparability, USMI believes that MI transparency should be used as a model for other forms of CRT in order to develop a simple, prospective, and transparent guide for lenders interested in participating in CRT arrangements. That is, with comparably transparent information made available *ex ante* for all types of CRT, the lender would have the premium rates for MI coverage that could be applied before the loans were purchased and guaranteed by the Enterprises. As a result, the lender would be able to determine whether a proposed CRT arrangement is competitive and attractive to its customers. Specifically, the GSEs should publish capital requirements and operational standards for all CRT counterparties. For each transaction, the names of counterparties, type of CRT and key terms, including pricing, amount of risk transferred, and amount, if any, by which guarantee fees are reduced, should be disclosed. In sum, USMI believes that MI provides the type of robust transparency that should be required for all forms of CRT.

We now turn to the ways in which front-end CRT such as deeper MI addresses the risks described in section III of the RFI:

- *Basis risk* – Mortgage insurers have always calculated losses in a manner that is very similar to the methodology used by the Enterprises, and they continue to work closely with the Enterprises and FHFA to refine MI master policies to minimize basis risk. MI is uniquely suited to managing basis risk on an individual loan level because MI coverage levels can be tailored to the loan. The Enterprises can manage MI basis risk through transparent pricing that properly gives effect to the reduction of risk associated with the MI coverage level, including the greater reduction of risk if deeper MI is selected for the loan.

- *Structure risk* – Almost by definition, entity-based MI generates less structure risk than back-end CRT structures because MI provides reimbursement for actual losses on a loan-by-loan basis. The only structural risk of MI is that borrower-paid MI may be cancelled before the loan is paid in full. As noted in the RFI, however, the vast majority of mortgage losses are expected to occur in the first 10 years of the life of a mortgage, and cancellation of MI in the first 10 years is rare, thereby minimizing this limited form of structure risk. Optional cancellations may increase as a result of rapid home price appreciation, but this structure risk is mitigated naturally because home price appreciation also results in a substantial reduction in default risk.

- *Pipeline risk* – Deeper MI generates no pipeline risk since credit risk is transferred before or simultaneous with the Enterprises' acquisition of the loan, reducing the risk of credit loss after acquisition but prior to inclusion in a CRT transaction.[14] The Enterprises do not warehouse risk with MI-based CRT programs.

- *Correlated business risk* – While mortgage insurers are in the same residential mortgage business as the Enterprises, they have a unique countercyclical capital model that substantially lowers the risk of failure in a housing market downturn. Specifically, state mortgage insurance laws require mortgage insurers to reserve 50 percent of premiums for a period of 10 years, to be used to pay claims during periods of stress. In addition, through PMIERs, the Enterprises have considerable insight into mortgage insurers and their risks, making possible the adoption of a highly informed approach to mitigating correlated risk. While other types of counterparties may not subject the Enterprises to elevated levels of correlated business risk, the other exposures of such counterparties are often opaque and outside the expertise of the Enterprises to monitor, measure, and manage.

- *Concentration risk* – The RFI points to the existing amount of aggregate credit exposure of the Enterprises to mortgage insurers as a potential reason for not engaging in additional amounts of MI-based CRT. USMI strongly believes that there is substantial capacity for increased MI-based CRT through deeper MI transactions that would be fully consistent with the Enterprises' safety and soundness. The Enterprises' exposure to mortgage insurers represents only about 15% of its total exposure to counterparties, which is less than the Enterprises' STACR/CAS-related exposure.[15] Moreover, the total

[14] Consistent with the above discussion, some measure of reimbursement risk remains after a mortgage with MI is acquired by an Enterprise.

[15] *See* Andrew Davidson, Credit Risk Transfer: Making a Successful Program Even Better (Feb. 2016).

exposure of the Enterprises to mortgage insurers must be understood in the context of recent enhancements to the financial soundness of mortgage insurers – especially the PMIERs – that mitigate the Enterprises' counterparty risk. In addition, increases in MI volume will be spread across multiple mortgage insurers, mitigating the risk of additional MI-based CRT.

- *Market risk* – Mortgage insurers have repeatedly demonstrated a commitment to maintaining a long-term presence in all geographic areas with stable pricing throughout the housing cycle.

MI-Specific Risks Discussed in the RFI

The RFI's description of MI-based CRT refers to the Enterprises' reimbursement risk, correlated business risk, and concentration risk in explaining why FHFA and the Enterprises have not yet focused on expanding the CRT role played by mortgage insurers in the wake of the financial crisis. Set forth below is additional information regarding mortgage insurer counterparty risk that USMI believes must be considered in order to fully understand the value of MI-based CRT and the role that mortgage insurers play to support the Enterprises' housing finance activities.

The Enterprises retain "reimbursement risk" with respect to their mortgage insurer counterparties, but at much lower levels than the credit risk to borrowers that they would otherwise have.

While the RFI recognizes that MI reduces credit risk on mortgages acquired by the Enterprises, it also refers to the fact that such mortgages remain guaranteed by the Enterprises notwithstanding the insurance; this in turn means that, when a borrower fails to make payments on an Enterprise-guaranteed loan, the Enterprise must pay the holder of the loan and then seek reimbursement from the mortgage insurer – creating reimbursement risk.

USMI strongly believes that the RFI's concerns with mortgage insurer reimbursement risk are overstated:

- First, as previously described, mortgage insurers engage in countercyclical reserving by collecting and reserving premium payments during favorable economic conditions so they can pay increased claims during market downturns.

- Second, the recently implemented PMIERs are expressly designed to measure, monitor, and control mortgage insurer counterparty risk by establishing robust standards for the companies' capital levels, business activities, risk management, underwriting practices, quality control, and lender approval and monitoring activities.

- Third, in October 2014, new MI master policies went into effect – following substantial input from FHFA – that increase clarity of terms and streamline the payment of claims to ensure that, in the event of borrower defaults, the MI results in reliable and predictable payments.

- Fourth, mortgage insurers have become substantially stronger than they were before the financial crisis through recapitalization and increased levels of capital.

- Finally, mortgages subject to MI are better underwritten as the result of legislative and regulatory changes since the financial crisis – in particular, the requirements for "qualified mortgages" and "qualified residential mortgages," which today are satisfied by the overwhelming majority of mortgages acquired or guaranteed by the Enterprises and insured by mortgage insurers. These better underwritten mortgages result in lower probabilities of default and lower expected loss given default, and this in turn means lower risk of loss to mortgage insurers and lower reimbursement risk for the Enterprises.

Most mortgage insurers weathered the financial crisis, and the few that exited were wound down in an orderly manner. With recent enhancements, mortgage insurers are well positioned to provide stable sources of CRT in the event of future market stress.

The RFI notes that "the aftermath of the recent housing crisis saw several mortgage insurers undergo severe financial difficulties, with several mortgage insurers being placed into run-off by state regulators and some mortgage insurers dropping below investment grade status." Since then, "FHFA and the Enterprises have focused on mitigating the counterparty risk of mortgage insurers."

Mortgage insurers, like many financial institutions, were tested during the United States' most severe financial crisis, which was squarely focused on defaulted residential mortgages. While three mortgage insurers exited the market, all others paid claims fully throughout the period of record mortgage losses, and the three that exited the market, as described below, continued to pay claims in run-off. Importantly, three new mortgage insurers entered the market during the crisis, ensuring that there was no interruption in the ability of mortgage insurers to meet demand, despite the severity of the market stress. And, since the crisis, the industry has undergone a significant increase in capitalization – mortgage insurers now hold nearly double the amount of capital required pre-crisis.

Moreover, even in those instances where market stress forced a mortgage insurer to exit the business, state insurance regulatory frameworks enabled that exit to occur in an orderly manner by providing processes to avoid the equivalent of a "run" on the insurer. These processes included the issuance by a state insurance regulator of an order requiring the insurer to pay claims in cash and deferred payment obligations to all policyholders, which occurred in an orderly manner throughout the housing crisis. Through the end of 2015, more than 96% of valid private MI claims in the crisis had been paid in cash, with less than 4% of claims outstanding in the form of Deferred Payment Obligations.

In contrast, the performance of back-end and entity-based CRT has a limited track record during market stress. Although the RFI posits that the extent to which investors will continue to invest in mortgage instruments through a housing downturn is uncertain, there is recent data tracking back-end CRT structures.[16] This data demonstrates that such structures have considerable volatility and pricing risk, which suggests that, unlike the MI market, a market for these structures may not exist in certain stressed environments.

Mortgage insurers fell below investment grade status during the financial crisis, but reliance on such ratings was unwarranted at the time and is unwarranted now.

The RFI notes that some mortgage insurers fell below investment grade status following the financial crisis. However, the credit ratings agencies issued a variety of ratings regarding mortgage insurers during the crisis, including with respect to the insurer and to the insurer's holding company. The housing industry and the Enterprises focused on the credit ratings of insurers' holding companies, which often had outstanding levels of unsecured debt, instead of focusing on the ratings of insurers and their claims payment abilities. In fact, mortgage insurers performed much better than their ratings reflect, as illustrated in the above discussion regarding mortgage insurers' payment of claims during the crisis.

Today, the financial and operational strength of mortgage insurers has substantially improved through the development and implementation of enhanced risk management, quality control, and financial requirements, all as required in the PMIERs; the strengthening of mortgage insurer master policies; and the significant improvements in required mortgage underwriting standards.[17] Indeed, the Enterprises were able to establish and calibrate the PMIERs precisely because they have a robust understanding of MI risks and how much capital mortgage insurers need to hold to mitigate those risks. In any event, the methodologies for credit ratings relating to residential mortgage securities have so drastically changed that ratings today are not comparable to crisis-era ratings and are not suitable for evaluating the risk of mortgage insurers.

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In sum, forms of front-end CRT such as MI align with the principles in the RFI and address risks in the RFI. Chart 3 analyzes MI versus other forms of CRT in terms of these principles and risks.

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[16] *See* Two Harbors Investment Corp., Credit Risk Transfer (Feb. 10, 2016).

[17] Section 939A of the Dodd-Frank Act requires a federal agency to replace references to credit ratings in its regulations with references to appropriate standards of creditworthiness. *See* 15 U.S.C. § 78o–7 (note). For example, FHFA has proposed changes to the Acquired Member Assets programs of the Federal Home Loan Banks in order to comply with section 939A. *See* 80 Fed. Reg. 78689 (Dec. 17, 2015).

Chart 3: Principles and Risks of Various Forms of CRT[18]

Goals:	Back-End Risk Sharing		Front-End Risk Sharing	
	CAS/STACR	**Reinsurance**	**Deeper MI**	**Lender Recourse**
Reducing taxpayer risk	Effective in good economic times; unclear in tough times	Poses modest counterparty risk, but can be addressed	Poses counterparty risk and risk of GSE-like monoline model, but both can be addressed	Poses modest counterparty risk, but can be addressed
Maintaining broad borrower access to credit	Effective	Effective	Poses risk of overlays and risk-based pricing, but both can likely be addressed	Poses risk of overlays and risk-based pricing, but both can likely be addressed
Maintaining broad access to the secondary market	Effective	Effective	Effective	Only available to large banks, which will put smaller banks at a disadvantage
Maximizing transparency	Effective	FHFA would need to require measures to make transparent	Effective	FHFA would need to require measures to make transparent
Minimizing volatility	Ineffective	Capital will be less fleeting than the capital markets, but more than deeper MI	Effective	Capital will be less fleeting than the capital markets, but more than MI
Mitigating risk in the financial system	Ineffective	Effective but structure likely limited in scope	How effective will depend on how counterparty and monoline issues are addressed	How effective will depend on how modest counterparty risk is addressed

[18] *See* Laurie Goodman, Credit Risk Transfer: Making a Successful Program Even Better (Feb. 2016).

Question A3: *In considering proposed front-end credit risk transfer transaction structures, how should FHFA and the Enterprises manage the counterparty risk involved in these transactions?*

The most effective way to manage counterparty risk is through the establishment of specific, detailed standards for counterparties to ensure they have adequate capital and liquidity and sufficiently robust risk management and internal controls to support the Enterprises' CRT activities. These standards should provide a level playing field that does not favor one counterparty over another. While they should be tailored to the particular type of counterparty, the PMIERs are an example of the types of standards that the Enterprises should establish for counterparties.

Indeed, subjecting mortgage insurers to the exacting PMIERs standards demonstrates the Enterprises' ability to effectively mitigate counterparty risk. Following a housing crisis that tested mortgage insurers' financial stability, mortgage insurers significantly grew their capital bases and implemented measures to enhance their operations, including through the revision of master policies to streamline the claims payment process and make it more predictable and reliable. The Enterprises issued PMIERs in proposed form and solicited comment from all interested persons, including the mortgage insurers. After incorporating some of the feedback received from interested persons, the PMIERs were finalized and went into effect on December 31, 2015. The resulting standards provide the Enterprises with deep insight into mortgage insurers' operations, financial status, and risk management. In order for mortgage insurers to engage in additional CRT such as deeper MI, the PMIERs would require modifications, but all such modifications can and should be made in the same transparent manner as the process followed by the Enterprises in issuing the PMIERs.

Because the Enterprises now have clear visibility into mortgage insurer operations and have a good grasp of the counterparty risk posed by individual mortgage insurers, FHFA and the Enterprises have a wealth of information that can be used to assess additional forms of CRT with mortgage insurers. The substantial majority of the Enterprises' CRT activities to date have been back-end, structure-based forms of risk transfer that involve cash collateral to mitigate reimbursement risk and other types of counterparty risk. However, these structures do not reflect the only way to mitigate counterparty risk for the reasons described above – they have not been tested during a housing crisis; they depend on market capacity; and they involve one-time structures as opposed to entities that can dynamically adjust to stressed conditions and are committed to the housing finance industry for their business, in both good times and bad. It is also not at all clear that collateralized structures are an economically viable option for CRT in scale. Finally, the counterparty risk from front-end CRT activities can be mitigated just as well as the risk from collateralized structures, and front-end CRT activities provide significant benefits to lenders and borrowers.[19]

[19] *See* Urban Institute, Credit Risk Transfer: Making a Successful Program Even Better (Feb. 10, 2006) (comparing deeper MI to CAS/STACR, reinsurance CRT, and lender recourse CRT).

Question A4: *In developing their credit risk transfer programs, the Enterprises have used pilot transactions to evaluate new credit risk transfer transaction structures. As FHFA considers proposed front-end credit risk transfer 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?*

USMI believes that pilot programs based on substantial volumes and a commitment from the Enterprises is a sensible first step in exploring CRT programs. Just as FHFA and the Enterprises effectively implemented STACR and CAS on a test basis making appropriate adjustments based on initial experiences, FHFA and the Enterprises should continue their efforts to design an appropriate pilot program for deeper MI that starts with modest volume but may be expanded over time with appropriate adjustments. The proof of this concept is necessary to validate deeper MI as a sustainable and beneficial form of CRT.

The issues to be tested in an MI pilot program should include the extent to which deeper MI would be available to both large and small originators alike; the ease of execution; and the amount of credit risk actually transferred.

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

Small lenders derive optimal benefits from CRT programs that are familiar, have minimal implementation costs, and are based on lender selection among several market participants. Accordingly, MI works very well for small lenders (and deeper MI similarly would work very well for small lenders) because it is already part of their current credit origination processes, is available with transparent pricing, and is available to lenders of all sizes. On the other hand, small lenders have no access to and derive no direct benefits from back-end forms of CRT.

Question B2: *Do other types of front-end credit risk transfer work better for small lenders than collateralized recourse transactions? How so?*

Collateralized recourse transactions are expensive for smaller lenders that cannot rely on economies of scale to offset costs such as the establishment of the special purpose vehicle necessary for such transactions. For that reason, collateralized recourse transactions traditionally have been reserved for larger financial institutions, but even larger institutions have had limited success[20] with these transactions due to their high cost. For the reasons set forth above, deeper MI is a lower cost and efficient source of CRT that could be made available to small lenders with relative ease and would benefit them more than collateralized recourse transactions.

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[20] According to the June 2016 FHFA CRT Progress Report, to date, there have been 12 collateralized recourse transactions representing less than half a billion RIF on UPB of $12.billion. *See* FHFA, Single-Family Credit Risk Transfer Progress Report (June 2016), *available at* http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Progress-Report-6292016.pdf

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

Guarantee fee pricing should fully recognize and take into account the risk-reducing benefits of CRT activities such as MI. Deeper MI would permit the Enterprises to reduce guarantee fees commensurate with the amount of risk transferred, and the models used by the Enterprises to compute guarantee fees should be transparent and their parameters made available to the public. The stability of MI pricing and MI's proven availability throughout the housing cycle would reduce the frequency and magnitude of required changes in Enterprise pricing.

Front-end CRT programs, particularly deeper MI, is less susceptible to market and investor volatility, such as the volatility experienced by back-end, structure-based CRT programs in early 2016, and therefore present a reduced need for mitigation from guarantee fees. Deeper MI is based on committed capital that is provided by mortgage insurers with a business model based on the housing finance system. Accordingly, mortgage insurer capital cannot be withdrawn and redeployed to another industry unlike back-end, structure-based CRT programs.

Question 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?*

Yes, a longer-term view for guarantee fees will ensure that the housing finance industry has sufficient diversity of market participants and therefore more stable capital and liquidity. While a longer-term view is important, an additional significant factor that will inform the market, the Enterprises, and FHFA about the performance of different CRT programs is to set guarantee fees based on transparent actuarial analysis of mortgage credit risk being incurred in order to fully reflect risk transferred to the private market.

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