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

October 13, 2016

RE: Single-family credit risk transfer request for input

Dear Director Watt:

Thank you for the opportunity to provide input to the Federal Housing Finance Agency on the single family credit risk transfer program. The choices that FHFA and the GSEs are making about how to transfer mortgage credit risk will have a significant impact on consumers and the broader housing finance market in the years to come.

While the credit risk transfer program has grown quite a bit since 2012, it is still in its early stages. In the coming years, FHFA will guide the development of new financial structures designed to shift mortgage credit risk away from the federal government. As FHFA oversees this development, it is critical that the agency prioritizes the needs of consumers. In FHFA's request for information, consumer risks and impacts were not included among FHFA's list of principles for evaluating credit risk transfer structures. Moving forward, FHFA should evaluate and take steps to mitigate any risks posed to consumers by particular credit risk transfer structures. FHFA should not permit the GSEs to engage in credit risk sharing transactions that will substantially raise prices for consumers or harm them in other ways.

In addition, FHFA should ensure that the Enterprises are transferring mortgage credit risk in a sustainable way. FHFA should monitor transactions closely for counterparty risk as the Enterprises move toward transactions that are partially collateralized instead of fully collateralized. FHFA also should play a more active oversight role in the design of credit risk transfer structures, to ensure they are designed in a way that transfers risk and is economically sensible for the Enterprises.

<u>Low and moderate-income borrowers should not pay more for insurance than others</u>

As the GSEs contemplate "front end" approaches to credit risk transfer that rely on deeper private mortgage insurance, they should consider how to do so without increasing costs for low and moderate income borrowers. If not designed properly, a shift toward deeper coverage could exacerbate existing factors pushing the GSEs increasingly toward risk-based pricing rather than risk pooling.

Historically, Fannie Mae and Freddie Mac served an important function in the housing market: pooling risk so that the cost of a GSE loan remained relatively stable across geographies and the credit spectrum. In our view, this is a critical function of the GSEs and the main reason that the GSEs merit a government guarantee.

However, when the GSEs entered conservatorship, the adoption of loan level price adjustors moved them away from risk pooling toward a more individualized approach, resulting in a prices premium for those lower on the credit spectrum or with higher LTVs of up to 375 basis points.[1]

Then, after FHFA instituted the PMIERs, or private mortgage insurance eligibility requirements, costs to GSE borrowers with average or below average credit or low down payments increased even more. During the comment period for the PMIERs, the Center for American Progress, national civil rights organizations and consumer groups cautioned that the proposed grids would require private mortgage insurers to engage in steep risk-based pricing that, layered on top of the LLPAs, would result in an even more skewed pricing structure.[2] Our groups recommended that FHFA require capital levels appropriate for the aggregate risk profile of an insurer's book rather than imposing granular, risk-based requirements for particular buckets of loans, or, alternatively, to remove the LLPAs given the increase in counterparty reliability occasioned by the adoption of the PMIERs. However, FHFA chose to keep the LLPAs while also proceeding on the path toward increased risk based pricing by the private mortgage insurers.

Not surprisingly, since implementation of the PMIERs, mortgage insurers have raised prices dramatically for those at the lower end of the credit score spectrum. According to the Center for Responsible Lending, borrowers at the bottom of the credit score spectrum now pay premiums that are four times higher than those paid by borrowers at the highest end.[3]

Moving forward, FHFA should take steps to reduce excessive risk-based pricing, which effectively shuts out many potential customers in a large portion of the theoretical credit box.

Should the GSEs decide to pursue a pilot that transfers credit risk through requiring deeper private mortgage insurance, they should take steps to prevent risk-based pricing and the types of dramatic premium increases that recently occurred after implementation of the PMIERS. One way to prevent excessive risk based pricing would be to require private mortgage insurance counterparties to set prices based on the risk of their overall book of loans, rather than at the loan level. If it is not possible to set such a standard, the GSEs could offset any cost increases to consumers by lowering the guarantees fee they charge, as the Urban Institute has recommended.[4]

<u>Credit risk investors should not influence GSE mortgage policies</u>

As the GSEs transfer more credit risk to the private sector, they should avoid making policy decisions based on perceptions about what will be attractive to credit risk investors. One current example is in the area of loss mitigation. As FHFA and the GSEs design new loss mitigation options for borrowers to put in place after HAMP expires at the end of this year, they should design the program that best meets the needs of homeowners and taxpayers. Decisions about the new loss mitigation program should not be influenced by preferences among current or potential buyers of GSE mortgage credit risk.

Managing counterparty risk

To date, most of the GSE credit risk transfer transactions have been fully collateralized transactions executed through the capital markets, limiting counterparty risk. As the GSEs expand beyond fully collateralized transactions and consider offering more partially collateralized transactions, they and FHFA should ensure counterparties are financially sound and well capitalized. They should also assess for business correlation and concentration risk.

In its request for input, FHFA identified the primary counterparty risks associated with increasing the GSE exposure to private mortgage insurers. Should the GSEs pilot a deeper mortgage insurance approach, CAP supports the Urban Institute's recommendations that FHFA consider managing counterparty risk by requiring insurers to post collateral, as they do with the back-end CAS and STACR deals and considering pool policy maximums to prevent the GSEs from being overly exposed to any one mortgage insurer.[5]

One area where FHFA should do further investigation and share more information with the public is the counterparty risk associated with large reinsurance counterparties. Last year, nearly one quarter of the credit risk transferred by the Enterprises was transferred through Freddie Mac's Credit Insurance Risk Transfer (CIRT) and Fannie Mae's Agency Credit Insurance Structure (ACIS) transactions, structures that typically transfer risk to reinsurance companies.[6] Although reinsurance companies tend to have more diversified lines of business when compared to private mortgage insurers and the GSEs, which helps to reduce correlation risk, more research may be needed to identify and mitigate any counterparty risks specific to this industry. Large, sophisticated and reputationally sound insurers can nonetheless be weak counterparties if poorly regulated and supervised. The history of AIG is a cautionary example.

FHFA should closely oversee design of credit risk transfer structures

The insights offered by the pilots about how the private sector will price risk or what structures transfer risk most efficiently have been limited because little real risk has been transferred. The amount of credit transferred has been small partly by design – the Enterprises are gradually sharing more risk as they build a more robust market for credit risk transfer structures – and partly because mortgage default risk is very low for recent GSE books of business.

However, it is also possible that structural inadequacies are undermining the potential effectiveness of the pilot. FHFA may need to play a more active oversight role in the design of transactions to ensure that the structures effectively transfer risk. For example, the design of these structures should prevent payouts to risk-baring counterparties before credit loss can reasonably be expected to occur.[7]

Conclusion

The credit risk transfer pilots can help FHFA and the GSEs explore the risks and benefits associated with various credit risk transfer structures. FHFA can improve these pilots by ensuring that the needs of consumers are prioritized, by closely overseeing the design of the credit risk transfer structures and by assessing for counterparty risk, especially with regard to partially collateralized structures.

Thank you again for the opportunity to provide input. Please email Sarah Edelman with any questions or to discuss further at sedelman@americanprogress.org.

Sincerely,

Center for American Progress
Consumer Federation of America

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[1] Fannie Mae, Loan Level Price Adjustment Matrix (LLPA), available at https://www.fanniemae.com/content/pricing/llpa-matrix.pdf (last accessed October 2016)

[2] Center for American Progress, Community Legal Services, Consumer Federation of America, Empire Justice Center, NAACP, Mortgage Finance Working Group, National Association of Consumer Advocates, National Council of La Raza, National Community Reinvestment Coalition, National Consumer Law Center, on behalf of its low-income clients to the Federal Housing Finance Agency, September 8, 2014 available at http://www.consumerfed.org/pdfs/CAP-PMIER-sign-on-letter-9-8-14.pdf.

[3] Center for Responsible Lending to the Federal Housing Finance Agency, October 13, 2016.

[4] Laurie Goodman, Jim Parrott, Ellen Seidman and Mark Zandi, *How to Improve Fannie and Freddie's Risk Sharing Effort* (Moody's Analytics and the Urban Institute August 2016) available at https://www.economy.com/mark-zandi/documents/2016-08-25-How-to-Improve-Fannie-and-Freddiess-Risk-Sharing-Effort.pdf.

[5] Ibid

[6] Division of Housing Mission and Goals, *Single-Family Credit Risk Transfer Progress Report* (Federal Housing Finance Agency 2016) at 10.

[7] See Timothy Howard, "Far Less Than Meets the Eye," Howard on Mortgage Finance blog, August 8,2016 available at https://howardonmortgagefinance.com/2016/08/08/far-less-than-meets-the-eye/.