The Honorable Mel Watt
Director
Federal Housing Finance Agency
400 7th Street SW, Eighth Floor
Washington, DC 20219

Re: CRL Comment Letter – Federal Housing Finance Agency (FHFA) Single-Family Credit Risk Transfer Request for Input - June 2016

Dear Director Watt,

The Center for Responsible Lending (CRL),[1] Corporation for Enterprise Development (CFED),[2] and the Leadership Conference on Civil and Human Rights (LCCHR)[3] file this comment in response to FHFA's request for input regarding the Enterprises' single-family credit risk transfer programs. Thank you for the opportunity to submit comments on this important subject. We thank FHFA for its careful attention to these programs, which must be designed to protect tax dollars and facilitate a well-functioning market for all homebuyers. The comments below address numerous questions on which FHFA requests input, including the goals and approach FHFA should take in assessing the programs and specific concerns we have about particular risk sharing structures.

The Enterprises' credit risk sharing programs create a buffer of private capital to absorb losses, insulating the Enterprises and by extension taxpayers from loss. Although the program mitigates credit risk, it introduces its own set of risks. In its Request for Input FHFA concentrates on describing, and seeks input primarily on the risks these programs introduce for the Enterprises (for example, counterparty and model risk). However, the program also has the potential to affect mortgage borrowers. The potential effects on current and future mortgage borrowers should be an important component of assessing the Government-Sponsored Enterprise (GSE) credit risk program and structure options. We are particularly concerned that front-end structures, including the proposed "Deeper MI", could structurally frustrate the Enterprises' statutory duties to create a well-functioning housing market and provide broad market access.

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[1] The Center for Responsible Lending (CRL) is a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, one of the nation's largest nonprofit community development financial institutions. Self-Help has provided $6 billion in financing to 70,000 homebuyers, small businesses, and nonprofits and serves more than 80,000 mostly low-income families through 30 retail credit union branches in North Carolina, California, and Chicago.

[2] CFED's work makes it possible for millions of people to achieve financial security and contribute to an opportunity economy. We scale innovative practical solutions that empower low- and moderate-income people to build wealth. We drive responsive policy change at all levels of government. We support the efforts of community leaders across the country to advance economic opportunity for all.

[3] The Leadership Conference on Civil and Human Rights is the nation's oldest and most diverse coalition of civil and human rights organizations. Founded in 1950 by Arnold Aronson, A. Philip Randolph, and Roy Wilkins, The Leadership Conference seeks to further the goal of equality under law through legislative advocacy and public education. The Leadership Conference consists of more than 200 national organizations representing persons of color, women, children, organized labor, persons with disabilities, the elderly, gays and lesbians, and major religious groups.

FHFA should consider the impact credit risk transfer structures might have on borrowers, in particular FHFA should consider potential effects on: 1) loan pricing, and thus access to credit, 2) loan quality and servicing, and 3) access for small lenders. In bringing in private capital, FHFA should be careful to ensure that FHFA does not exchange access to credit or borrower protections for the capital the private market offers. We are concerned that the credit risk transfer programs have the potential to:

- **Increase prices for certain borrowers** which would effectively limit access to credit for some creditworthy borrowers. Recent pricing changes by mortgage insurance (MI) companies illustrate this risk. These risks are most acute for, but not entirely limited to, front-end credit risk transfer structures.
- **Reduce incentives for strong quality control.** As the Enterprises cede credit risk they must continue to ensure quality origination and servicing. Borrowers should receive quality loans as well as loan modification and foreclosure prevention opportunities in the same way they would have had the Enterprises retained credit risk.
- **Favor larger lenders over smaller lenders** which would also effectively limit access to credit for borrowers by limiting the set of lenders who provide loans. Some front-end structures, by virtue of their complexity, are effectively only open to larger lenders. If these structures create market pricing advantages, small lenders will be disadvantaged in the mortgage market.

Finally, we are very concerned about calls for the Enterprises to lay off increased credit risk to Private Mortgage Insurers (PMI) through proposed Deeper MI structures. Expanding the amount of credit risk shouldered by these companies amplifies existing risks for the Enterprises. More importantly, the front-end nature of this structure and the pricing practices of these actors raise serious questions about the impact Deeper MI would have on access to credit and a well-functioning housing market.

Section 1: Implications for pricing and access to credit:

An important component of any credit risk transfer structure is how the entity taking on the credit risk will be compensated for the risk it takes on. In back-end credit transfer structures (such as the STACR or CAS structures) the GSEs pay the private entities for taking on credit risk. FHFA estimates this cost in terms of "guarantee fee concessions" in its 2016 report on credit risk transfer programs.[4] Guarantee fee (g-fee) concessions do not affect borrower pricing directly because the Enterprises set the guarantee fee independent of the risk transfer transaction. In other structures, particularly in front-end structures, borrower pricing is more likely to be affected by the credit risk transfer structure as the compensation for taking on credit risk is likely to be built into up-front borrower pricing.

As described in the Request for Input, the current structure of Private Mortgage Insurance provides credit risk protection for the Enterprises as part of their "credit enhancement" requirements. In this structure MI companies charge a premium, paid by borrowers, for the credit risk they take on for each individual loan. A look at the pricing structure of MI companies compared to Enterprise guarantee fees gives an indication that front-end credit risk transfer structures may change prices for borrowers. We are concerned that private market entities will charge borrowers vastly different prices based on narrow

[4] See pages 17-20 of FHFAs Single Family Credit Risk Transfer Progress Report, June 2016. Available at: http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Progress-Report-6292016.pdf

credit score bands, which will result in access to credit being even more limited for borrowers with lower credit scores.

Comparing the Enterprise guarantee fee structure to the MI pricing structure reveals the private market's tendency to create finely defined bands. Enterprise guarantee fee pricing[5] breaks up credit scores into three bands: >=740, 700-739, and 620-699. From December 2013 to April 2016, MI companies broke up this same range into four bands: >=760, 720-759, 680-719, and 620-679. The most recent set of MI pricing, released in April 2016,[6] breaks this same range of credit scores into eight different bands: >=760, 740-759, 720-739, 700-719, 680-699, 660-679, 640-659, and 620-639.

Finely defined pricing frameworks facilitate charging different prices for different borrowers. The Table below shows the change in basis points borrowers with a given credit score saw as a result of PMI pricing changes implemented in April 2016. Some borrowers, those with credit scores above 740, enjoyed a reduction in fees whereas others, almost all borrowers with scores below 680, saw increases. The cells highlighted in the dark green saw a decrease of more than 30 basis points. The cells highlighted in dark orange saw an increase of more than 30 basis points.

Change in MI pricing by Credit Score (December 2013 to April 2016)

	97-95.01% LTV 35% Coverage	95-90.01% LTV 30% Coverage	90-85.01% LTV 25% Coverage	85% LTV and under 12% Coverage
>=760	-50	-13	-9	-4
740-759	-35	-3	-3	-7
720-739	-15	11	6	-4
700-719	-16	-2	3	-6
680-699	9	19	16	-1
660-679	42	27	29	2
640-659	57	35	34	4
620-639	77	46	39	6

Additionally, the range of prices paid from the lowest to the highest increased significantly. Prior to the change, prices ranged 43 basis points (from 105 to 148 basis points) across the credit score spectrum for borrowers with LTVs 97-95.01 and 35% coverage. After the change, prices ranged 170 basis points (from 55 to 225) for the same spectrum. Borrowers with the lowest scores now pay more than 4 times as much as borrowers with the highest scores. This is in contrast to the Enterprises' prices, which vary by much less across the credit score spectrum. For example, for loans with LTV from 60-80% g-fees range 25 basis points (from 82 to 57) depending on credit score.

Price is important to focus on because it, along with underwriting standards, provides the mechanism by which borrowers are granted access to the mortgage market. Allowed to operate unchecked, market incentives can result in only the least risky borrowers having access to home loans.

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[5] As described in FHFA's 2015 "Fannie Mae and Freddie Mac Guarantee Fees: Request for Input"

[6] Pricing from Genworth and Radian

The Enterprises already heavily cater to the least risky borrowers—borrowers with wealth who could access affordable credit most easily in a private market. The Urban Institute's Credit Availability Index has fallen to 5.6, less than half of where it stood in the late 1990s and early 2000s.[7] The average credit score on new originations has risen to over 750, up more than 40 points in the last decade.[8] Only 38% of the US population that has a credit score has a score of 750 or higher.[9]

Higher income and white borrowers tend to have higher credit scores.[10] For example, a Federal Reserve study found that 46.7% of Whites had scores in the top 40% of the distribution of VantageScores, but only 10.8% of Black/African-Americans and 22.6% of Hispanic/Latinos had a score that high.[11]

Existing wealth disparities rooted in previous historic federal housing policy advantaging White borrowers and disadvantaging African-Americans contributes to differences in credit scoring among racial and ethnic lines.[12] Further, recent abusive practices in the subprime mortgage market targeted neighborhoods of color, resulting in spillover effects that damaged the credit of many homeowners of color. As a result, borrowers of color have become a smaller share of mortgage borrowers even as their share of the population has risen, and despite a history of success in homeownership when receiving loans without risky product features.[13]

According to recently released Home Mortgage Disclosure Act (HMDA) data, only 2.7% and 5.1% of conventional loans in 2015 went to Black and Latino borrowers (respectively).[14] Furthermore, the Enterprises have struggled to meet their Affordable Housing Goals even as those goals have fallen. Fannie Mae met both the benchmark and the market single-family low income home purchase goal only once between 2010 and 2014. Freddie Mac failed to meet one or both single-family low income home purchase goals in each one of these years.

	Low Income Home Purchase Goal		Low Income Home Purchase Performance	
	Benchmark	Market	Fannie Mae	Freddie Mac
2014	23%	22.8%	23.5%	21.0%
2013	23%	24.0%	23.8%	21.8%
2012	23%	26.6%	25.6%	24.4%
2011	27%	26.5%	25.8%	23.3%
2010	27%	27.2%	25.1%	26.8%

[7] See http://www.urban.org/policy-centers/housing-finance-policy-center/projects/housing-credit-availability-index

[8] See http://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-april-2016 (pg 14)

[9] See http://www.fico.com/en/blogs/risk-compliance/us-credit-quality-continues-climb-will-level/

[10] See https://www.federalreserve.gov/boarddocs/rptcongress/creditscore/performance.htm

[11] Ibid, Table 14B

[12] *See* National Consumer Law Center's Racial Justice and Equal Economic Opportunity Project, *Past Imperfect: How Credit Scores and Other Analytics "Bake In" and Perpetuate Past Discrimination*, https://www.nclc.org/images/pdf/credit_discrimination/Past_Imperfect050616.pdf

[13] UNC Center for Community Capital, Community Advantage Panel Study: Sustainable Approaches to Affordable Homeownership, http://ccc.unc.edu/contentitems/community-advantage-panel-study-sustainable-approaches-to-affordable-homeownership/

[14] See hhttp://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/2015_hmda_policy_brief_2.pdf

Access to credit for all creditworthy borrowers is essential not only for the households discussed above, but also for the entire housing market as these households are critical for the overall market to work. It has been projected that nearly half of first time homebuyers in 2025 will be households of color.[15] First time homebuyers are an important segment of the market that support new home construction and enable existing homeowners to trade up.

In this context, FHFA should be very cautious about pursuing credit risk transfer structures that have the potential to limit access to credit and as a consequence, undermine the mission of the GSEs to increase liquidity in the market, especially for underserved populations. Front-end credit transfer structures transfer price setting power as well as credit risk. As recent PMI pricing changes show, pricing power in private hands results in greater price differentiation by credit score. Higher prices for borrowers with lower credit scores limits access to mortgage credit for these borrowers. FHFA should consider the effects on access to credit when assessing credit risk transfer structures. Back-end structures create less risk of exacerbating differential pricing as long as the GSEs continue to build in average pricing into the process of setting g-fees.

Section 2: Implications for loan quality and servicing:

Borrowers deserve protections when loans are originated and once they are on the books, regardless of if a loan is part of a back-end or front-end credit risk transfer deal. By design, all of the credit risk transfer structures (both front-end and back-end) reduce the GSEs financial interest in the performance of any one loan. FHFA should carefully monitor the GSEs to make sure that this reduced financial interest doesn't result in a reduction in quality control either at loan origination or in the course of loan servicing.

Furthermore, increasing the number of parties holding the risk may complicate servicing, particularly in the loan modification process. Once a loan is originated and sold to one of the Enterprises, borrowers deserve to have their loan well serviced and to have access to effective loan modifications regardless of who holds the credit risk. Credit risk transfer structures increase the number of actors with a financial interest in a loan's performance. As we saw in the crisis, it can be harder for borrowers to get effective and economically meaningful loan modifications when their loan involves multiple parties with different, and possibly competing, financial interests in the loan modification. The involvement of multiple parties increases the odds that the party controlling the servicing and loan modification decisions will not be aligned with the economic outcome of the loan modification. In other words, the party that incurs the costs for modifying the loan is not fully realizing the benefit of the modification. During the mortgage crisis, misaligned incentives were a major cause of the miniscule number of completed loan modifications to prevent foreclosures. FHFA should carefully monitor the servicing of loans that are part of front-end and back-end credit risk transfer programs to make sure borrowers continue to receive robust and effective loan servicing.

Section 3: Implications for small lenders:

[15] See http://www.jchs.harvard.edu/research/state_nations_housing

An important method of maintaining access to credit for borrowers is to make sure all lenders can access the secondary market. The various credit risk transfer structures discussed in FHFA's request for input maintain access for small lenders by leaving the Enterprises' loan purchase and pricing processes unchanged. This effectively maintains equal access for all lenders. However, changes in the way the Enterprises purchase loans, particularly some front-end credit transfer structures, have the potential to disadvantage small lenders.

Lender recourse front-end credit risk transfer structures are too complicated and costly for small lenders. For example, collateralized recourse transactions (like the L Street Securities transactions) require sophisticated analytical capacity, a large amount of cash collateral, as well as tying up collateral for long periods of time. Such costs could be a reasonable investment for a large institution which has many loans, but are not feasible for smaller lenders.

FHFA has disclosed little about the details of these transactions. Even so, we know that lenders engaged in these transactions receive a discount on the g-fees charged by the Enterprises. FHFA should ensure that lenders who are able to conduct credit risk transfer transactions do not receive pricing breaks from the Enterprises that give them a market advantage over small lenders. Pricing should be considered both at the overall level and the distribution of pricing across credit scores.

Back-end transfer structures maintain access for small lenders more effectively. They leave the method by which the Enterprises purchase loans from originators unchanged and do not change the price lenders (and by extension borrowers) pay for securitization. However, small lenders likely cannot participate as investors in these structures. As FHFA points out, only 1% of the investors in the Enterprises' back-end credit risk transfer transactions completed in 2015 were banks or credit unions (of any size).[16]

Section 4: Concerns about proposed "Deeper MI":

As discussed in FHFA's request for input, the Enterprises already lay off a substantial amount of credit risk to MI companies. The Enterprises' charters limit their purchases to loans with an LTV below 80%. Private mortgage insurance is the most common method borrowers use to meet this requirement when they do not have the resources for a substantial down payment. According to the RFI, $724.5 billion of outstanding loans had private mortgage insurance at year-end 2015. In contrast, the STACR and CAS back-end transactions cover $12.7 billion of outstanding unpaid principal on Enterprise loans. Credit risk transfer structures that rely even more heavily on private mortgage insurers carry an important set of risks.

We believe any front-end risk-transfer is likely to result in increased risk-based pricing and result in further barriers to responsible mortgage credit, including proposed Deeper MI. As discussed above, recent changes in MI pricing reveal the preference of these companies to segment borrowers by credit score and charge significantly different prices for borrowers with different scores. If MI companies covered a greater amount of credit risk, we would expect them to charge for that in a similar manner to the method they currently use to price their credit risk. We are deeply concerned about access to credit, particularly for non-white and low-income potential mortgage buyers under this pricing structure.

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[16] See FHFAs Single Family Credit Risk Transfer Progress Report, June 2016. Available at: http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Progress-Report-6292016.pdf

Expanding this practice to a greater amount of credit risk would likely result in a further reduction in access to mortgage credit.

Structures that provide cash collateral for losses insulate the Enterprises from counterparty risk. However, Deeper MI does not have such a high degree of counter-party risk protection. As FHFA identifies in the RFI, the Enterprises already have significant exposure to MI companies. Additionally, since these companies are in the same line of business as the Enterprises, their exposure is "wrong way risk." In a housing market downturn both the Enterprises and the MI companies would be exposed, calling into question the stability of MI credit risk protection in a housing downturn. Furthermore, MI companies engage in reinsurance transactions of their own which open up the Enterprises to counterparty risk to the reinsurers as well as to the MI companies. The Enterprises have substantially less control over this remote counter party risk.

Finally, the proposed Deeper MI structure of credit risk transfer has the potential to disadvantage small lenders. MI companies compete with each other for business through lender originators. In the past, this competition has resulted in MI companies engaging in kick-back arrangements in exchange for loan business.[17] The focus of this competition has been large lenders, which disadvantages smaller lenders.

Conclusion

It is difficult to identify the business justification for front-end credit risk-transfer structures when the Enterprises have other structures for transferring credit risk at their disposal. To justify a structure that by its nature is incentivized to decrease access to mortgage credit for creditworthy borrowers and advantages some lenders over others, FHFA would need to either put in place strong prohibitions on differential pricing or articulate a compelling business reason for advantaging this structure over others.

FHFA must responsibly protect taxpayer dollars. However, this should not be FHFA's only goal. The Enterprises must provide a public good in exchange for the support of taxpayers. Access to credit for all creditworthy borrowers, ensuring strong standards for borrowers, and ensuring equal market access for all lenders are equally important obligations for the GSEs. Concerns for FHFA and should be considered in designing, implementing, and evaluating the Enterprise credit risk transfer programs.

Sincerely,

CENTER FOR RESPONSIBLE LENDING

CORPORATION FOR ENTERPRISE DEVELOPMENT

LEADERSHIP CONFERENCE ON CIVIL AND HUMAN RIGHTS

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[17] In 2013, 4 national MI companies settled with the CFPB over captive reinsurance arrangements with lenders. http://www.consumerfinance.gov/about-us/newsroom/the-cfpb-takes-action-against-mortgage-insurers-to-end-kickbacks-to-lenders/

Specific responses to RFI 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 Section II and III."*
Section II contains two areas we think should be carefully considered when assessing credit risk transfer structures: "Continuity of the core business" and "Stability through all economic and housing cycles." Both of these areas speak to how the structures might affect borrowers. FHFA should consider the impact credit risk transfer structures might have on borrowers, in particular the implications of the structures for: 1) loan pricing and thus access to credit, and 2) loan quality and servicing. Section III does not include risks to borrowers that originate from the credit risk transfer structures. We suggest FHFA consider the potential risks to borrowers that these structures introduce in addition to risks to the Enterprises.

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?*
Unlike back-end structures where the GSEs set the g-fee, front-end structures would require private-market actors to set the fees to cover this credit risk. We are concerned about the effect these structures would have on pricing, and thus access to credit, for borrowers.

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 of characteristics should be tested in pilot transactions."*
FHFA should evaluate the pricing offered to borrowers across the FICO/LTV grid in assessing the impact of any front-end credit transfer structure on borrower access to credit.

Question B1: *"What credit risk transfer strategies work best for small lenders? Why?"*
Small lenders face a number of challenges in participating in the credit risk transfer structures proposed and used by the Enterprises. Small lenders may not have the up-front collateral required to participate in a lender recourse structure or be willing to tie up their collateral for as long as required by the Enterprises. Small lenders may lack the analytical capacity to assess the credit risk in a pool of loans. Small lenders may also simply not produce enough loans to justify the investment of time and resources to set up a front-end credit risk transfer arrangement. Small lenders are also unlikely to invest in back-end credit risk transfer securities. FHFA should ensure small lenders continue to have the same access to the secondary market they enjoy today. The implications of pricing changes should also be carefully considered as to the effect on small lenders. If credit risk transfer structures change loan level pricing in the market, small lenders may also be effected through market pressure.

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?"*
The results of the credit risk assessments of private-market actors should be only one factor considered in assessing g-fees. While these results provide helpful information about the amount and cost of bearing credit risk, FHFA and the Enterprises have a statutory obligation to also consider access to credit. In setting g-fees, the FHFA should continue to incorporate their interest in preserving access to

credit in addition to setting aside enough capital to cover losses. We are concerned about the demonstrated tendency of private-market actors to finely price risk by FICO/LTV which has resulted in low prices for some borrowers and high prices (often 4 times as high) for other borrowers.