October 3, 2016

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

Re: CMLA Comment Letter – FHFA Single Family Credit Risk Transfer
Request for Input – June 2016

Dear Director Watt:

The Community Mortgage Lenders of America (CMLA) is pleased to submit this comment letter on FHFA's Request for Input on Single Family Credit Risk Transfer.

CMLA is in favor of upfront risk sharing by Fannie Mae and Freddie Mac (collectively the GSEs) with the following conditions:

1. All upfront risk sharing is done on a pool level;
2. If upfront risk sharing is done through a mortgage insurance policy offering deeper mortgage insurance (deeper MI) coverage there should be:
    a. A prohibition on volume discounts
    b. Pricing transparency
    c. Equal access and equal pricing for all lenders
    d. Identical credit parameters for all lenders
    e. Uniform reductions in the guaranty fees for specific levels of deeper mortgage insurance coverage
3. Upfront risk sharing done upon the basis of recourse must meet these requirements:
    a. The originating lender must be legally obligated for the recourse under the risk sharing agreement and the agreement must not permit the shifting of this obligation through any capital markets device such as the issuance of securities or other capital markets instruments

    b. All such risk sharing should be fully collateralized by the posting of liquid, highly safe securities such as U.S. Treasuries or equivalent securities
    c. Equal access and equal pricing for all lenders must be mandated under this form of risk sharing
    d. Uniform reductions in the guaranty fees for specific levels of recourse
4. There should be a strict prohibition against Fannie and Freddie discriminating in any way, be it pricing, access or participation, against a lender that does not participate in upfront risk sharing.

<u>Primary Objective of Risk Sharing</u>

As we all learned in the experiences of the 2008 Financial Crisis, the GSE business model, while offering a number of advantages to the U.S. mortgage market, contains one large disadvantage – a concentration of mortgage market credit risk that can create devastating financial losses when widespread job losses create a large number of mortgage defaults, which in turn drive significant losses in home values.

Risk sharing is a way to deal with this drawback in the GSE business model, while offering a way to retain the advantages. However risk sharing must be done in a cost-effective manner, so that the GSEs are receiving good value for the income they forego, or costs they must pay, for the risk sharing. Additionally the risk sharing that is done must truly shift the risk of loss away from the GSEs and onto the risk sharing partners under a wide variety of loss scenarios and cannot be confined to once in a lifetime economic catastrophes for there to be any meaningful risk sharing.

The real estate market is highly cyclical. Economic downturns that are of a lengthier duration, or of greater severity, create job losses, which in turn drive mortgage defaults. At a certain point widespread mortgage defaults, coupled with a slow down in sales due to economic uncertainty, depress home values. These two factors determine the amount, and severity, of foreclosure losses. While we cannot necessarily predict with any precision when these downturns will occur, or their length or severity, we know that they will occur and risk sharing must be designed to lessen the financial impact upon the GSEs when they do.

<u>Equal Pricing and Equal Access are Paramount Considerations</u>

We commend the Federal Housing Finance Agency (FHFA) for its outstanding work in reversing the disastrous pricing discrimination policy practiced by Fannie Mae and Freddie Mac in the pre-2009 era. Prior to the crisis Fannie and Freddie routinely extended highly favorable pricing to the large, bank-owned mortgage lenders, by discounting guaranty fees in return for business volume. This policy distorted the mortgage market by disadvantaging small and mid-size community-based lenders and the consumers they serve. It led to a concentration of lending volume and loan servicing among a handful of large, bank-owned lenders.

In addition it led to a concentration in the issuance of GSE securities, to a small number of securities firms that were affiliates of the same banks that owned the large mortgage lenders that obtained the favorable pricing from the GSEs.

If the 2008 Financial Crisis taught us nothing else, it is that this type of market concentration, into a handful of extremely large, too-big-to-fail (TBTF) firms, is very dangerous, both from an economic and policy standpoint. Such a concentration literally forces regulators and policy makers into a corner during times of extreme financial distress, with the choice of bailing out these TBTF firms or facing a market calamity on the scale of the 1930's Great Depression.

We are very concerned that without strict rules, and stringent oversight by FHFA as conservator and regulator of the GSEs, that upfront risk sharing could be the path for the return to the marketplace of discriminatory pricing in favor of the large lenders, particularly those that are owned by banks with securities affiliates. Our concern on this matter has been fueled by three factors:

1. The lack of transparency on the few upfront risk sharing transactions that have been done to date, all of which, we would note, have been done with large lenders with securities affiliates;
2. The complete disinterest exhibited by both GSEs in exploring an upfront risk sharing transaction with a well-capitalized, independent, community-based lender.
3. Recent reports regarding FHFA's directive to both GSEs that they must charge the minimum guaranty fee to all lenders who sell loans to the GSEs through the swaps channel.

The lack of transparency is especially troubling because we have no way to determine if the upfront risk sharing transactions are being used by the large lenders to regain the pricing advantage they once enjoyed, and used to dominate the marketplace to the disadvantage of small and mid-sized lenders and the consumers they serve.

We can attest to the complete disinterest of the GSEs in exploring upfront risk sharing with small lenders based on the experience of one of our members, who has tried repeatedly to engage in meaningful negotiations on an upfront risk sharing transaction, and has been unable to do so. This is a clear indication to us that absent strong rules and stringent oversight by FHFA, that the GSEs will make upfront risk sharing the exclusive province of the large, bank owned lenders with securities affiliates.

The recent report that FHFA issued a directive to both GSEs mandating that they charge the minimum guaranty fee of 44 bps to all lenders selling loans through the swaps channel was also disturbing to us. The report added to our conviction that the GSEs will revert to their pre-2008 methods of discounts on their guaranty fees to large customers without strict oversight. That tendency, combined with pressure from large customers, and with the overlay of the ability of large customers with securities affiliates to employ financial structuring with securities issuances to shift the risk to third parties, reinforces our conviction that any risk transfer permitted with the use of the recourse provision must be strictly regulated.

<u>Policy Considerations</u> – Upfront risk sharing with deeper MI

The option to participate in upfront risk sharing through the use of deeper MI coverage should appeal to a number of mid-size and small lenders who seek to participate in upfront risk sharing. The conditions outlined above will be absolutely critical to ensure that this form of risk sharing is not utilized by large, bank owned mortgage lenders with securities affiliates to re-assert their dominant, and concentrated, position in the mortgage market place. Discussions with the mortgage insurance industry have assured us that facilitation of re-concentration through their participation in upfront risk sharing is not their intent, and we believe the conditions outlined above will prevent such re-concentration.

We understand that FHFA and the GSEs have concerns regarding a concentration of risk with the MIs as counterparties, a concentration that would be exacerbated by widespread use of deeper MI coverage for upfront risk sharing. Fortunately there is an easy remedy for such concentration of risk.

The remedy would be to require each approved mortgage insurer that seeks to offer deeper MI coverage for upfront risk sharing to re-insure a portion of the additional risk with non-affiliated, third party reinsurers that are not mortgage insurers themselves. Such a requirement would create a dispersion of risk, beyond the mortgage insurance industry, and lessen the valid concerns about a concentration of risk among a limited number of counterparties.

A uniform set of rules and standards for such reinsurance could accomplish two worthwhile goals:

1. Mortgage credit risk would be spread to a larger number of counterparties, who themselves have a larger variety of risks that are not correlated to mortgage risk. As the 2008 Financial Crisis taught us, correlated risk can overwhelm the most sophisticated modeling and create significant, unanticipated losses that can far exceed seemingly robust capital standards
2. A reinsurance requirement for deeper MI could very well serve to create a more robust market among reinsurers for reinsurance of mortgage credit risk in general, which FHFA and the GSEs may look to as a way to lessen further the concentration of counter-party mortgage credit risk with the MI industry.

   There is no substitute for the depth of experience, the broad web of customer relationships and level of service that the MI industry provides to lenders, nor to the key role played by mortgage insurers in facilitating low down payment lending for borrowers whose home finance needs are served with a low down payment mortgage. However the concerns of FHFA and the GSEs about the concentration of counter party risk represented by the MIs can be addressed through more widespread use of third party reinsurance with well-capitalized and unaffiliated reinsurers to disperse the risks away from the MI industry.

It will be extremely important that the reinsurance rules guarantee that meaningful risk, at default and loss levels likely to be encountered in moderately severe economic downturns, be shifted to third party, unaffiliated reinsurers.

Policy Considerations – Upfront risk sharing through lender recourse

Upfront risk sharing utilizing lender recourse is much more problematic with respect to the possibility of this type of risk sharing becoming the pathway to distorted pricing and concentration or risk that existed in the pre-2009 mortgage marketplace. In addition low and moderate income borrowers, those with lower credit scores or those seeking low down payment loans could very well find mortgage credit difficult to obtain should the market become dominated by upfront risk sharing transactions.

Our concern is focused particularly on the large, bank-owned lenders that have securities firm affiliates. Without strict standards and rules these firms would have the ability to shift the risk they assume through recourse upfront risk sharing with the GSEs and to use the discounted guaranty fees that would be part of these upfront risk share arrangements to re-concentrate the market, both on the origination front as well as the servicing front.

These lenders would have every incentive to extend mortgage credit only to borrowers with substantial equity in their homes and pristine credit histories, while excluding low and moderate income borrowers, those with less than perfect credit histories and borrowers requiring low down payment mortgages. Such borrowers present a higher risk profile and the economics of upfront risk sharing would create strong financial incentives for large lenders to avoid extending credit to such borrowers.

Without the conditions we set forth earlier in this letter these integrated firms would be able to assume their formerly dominant positions in the mortgage market, to the detriment of small and mid-sized lenders and the consumers whose needs they serve. Such dominance would be re-achieved through the favorable guaranty fee pricing these integrated firms would receive, while they would utilize the capital markets access afforded by their affiliate securities firm to shift the risk associated with the recourse provisions to third party investors.

Prohibiting the shifting of recourse risk away from the lender originating the loan, and requiring that all such recourse risk be fully collateralized will block the re-concentration of both the originations, as well as the loan servicing, markets. These requirements will neutralize the ability of large lenders with securities market affiliates from obtaining the advantages, with the costs or obligations or upfront risk sharing and using those advantages to re-assert their pre-2009 market dominance with the attendant concentration of risk on the origination and servicing fronts.

Thank you for the opportunity to comment on this matter. Feel free to contact our Executive Director, Glen Corso (gcorso@thecmla.com or 202-827-9989) should you have any questions.

Sincerely,

COMMUNITY MORTGAGE LENDERS OF AMERICA