September 29, 2016

To: Federal Housing Finance Agency

 Office of Financial Analysis and Modeling

 400 Seventh Street, N.W.

 Ninth Floor

 Washington D.C. 20219

From: Timothy Howard, Former Vice Chairman of Fannie Mae\*

Re: Request for Input on Credit Risk Transfers

Submitted via Electronic Delivery to: [www.FHFA.gov](http://www.int.fhfa.gov/)

I appreciate the opportunity to respond to your request for input on the important topic of credit risk transfers for single-family mortgages owned or guaranteed by Fannie Mae or Freddie Mac. While the focal point of your request is “front-end” risk sharing (done prior to a loan being acquired by the companies), you correctly state, “FHFA must assess all Enterprise credit risk transfer activities using the same key principles and considerations….” My comments are aimed at this broader objective.

Any discussion of Fannie and Freddie’s risk-sharing alternatives has to begin by acknowledging the highly unusual circumstances under which the companies and FHFA, their regulator and conservator, currently operate. While Fannie and Freddie both are profitable, the terms of the 2012 net worth sweep imposed by Treasury prevent them from building capital (and will lead to their having no capital at all at the beginning of 2018). Treasury has made no secret of its desire to see Fannie and Freddie “wound down and replaced” with some alternative secondary mortgage market mechanism. Yet it has no statutory authority or ability to produce this result, and the actions it has taken with the net worth sweep and in other areas have been challenged in numerous lawsuits, under several different theories of law.

A victory for Treasury in these suits would keep Fannie and Freddie without capital and under FHFA conservatorship until they either are nationalized or replaced. In contrast, a victory by plaintiffs would reverse the net worth sweep and allow the companies to retain their earnings and regain access to the public capital markets. Pursuant to a capital plan filed with and approved by FHFA, they then would have a path to return to their former status of fully capitalized, shareholder-owned entities.

FHFA’s request for input on credit risk transfers by Fannie and Freddie thus comes at a time when their future capital circumstances are highly uncertain. As discussed below, however, irrespective of which of the (diametrically opposite) outcomes for the companies FHFA views as being more likely, it should take the same approach to assessing the economics of their risk-sharing transactions.

In its role as conservator, FHFA has the duty to “preserve and conserve the assets of” two companies, Fannie and Freddie, that have a proven and successful model of taking and managing mortgage credit risk. As companies with private shareholder capital, Fannie and Freddie always have had strong incentives to carefully assess and manage the mortgage credit risks they take, and their unique business model has enabled them to do so. They control credit risk on the front end through prudent underwriting standards and their ability to impose those standards on lenders who request a credit guaranty. The companies then minimize the cost of providing those guarantees through a unique and highly effective form of risk diversification—in very large volumes, and across products, risk characteristics, geography and time.

The value of Fannie and Freddie’s credit guaranty business process was proven during the financial crisis, when the delinquency and loss rates on the loans they owned or guaranteed were one-third those of loans made and held by commercial banks, and an even smaller fraction of the loans financed through private-label mortgage-backed securities. But the crisis revealed that capital requirements for all mortgage lenders, including Fannie and Freddie, were too lax. The Housing and Economic Recovery Act (HERA), passed in July 2008, included a provision intended to address this problem. Section 1110 of HERA states, “The Director [of FHFA] shall, by regulation, establish risk-based capital requirements for the enterprises to ensure that the enterprises operate in a safe and sound manner, maintaining sufficient capital and reserves to support the risks that arise in the operations and management of the enterprises.”

FHFA will not be able to assess “whether [risk transfer] transactions are cost-effective” alternatives to having Fannie or Freddie bear credit risks themselves unless and until, as regulator, it follows through on the directive in HERA and develops and promulgates updated, binding risk-based capital standards for the companies.

FHFA should do this immediately. The Federal Reserve has identified a 25 percent nationwide drop in home prices as the “severely adverse” scenario against which large and systemically important companies must be able to protect themselves. To determine the amount of initial capital Fannie and Freddie should be required to hold, by product type and risk category, to survive that level of stress, FHFA would use the companies’ historical loan performance data and reasonable targets for their return on capital to make projections of their cash credit losses, guaranty fees and administrative expenses under a scenario in which home prices fall by 25 percent. (FHFA also should update the capital requirements for the companies’ multifamily and portfolio investment businesses, which have risks different from the single-family business.) Updated to meet current standards of taxpayer protection, these single-family capital requirements and target guaranty fees, by product type and risk category, would become the reference points for FHFA to use in evaluating all potential forms of credit risk-sharing mechanisms, whether front-end or back-end.

FHFA should adhere to a “borrower benefit” standard in making these evaluations: specifically, will the risk sharing techniques or transactions in question result in a lower all-in cost to the borrower, with the same or a better standard of protection for the companies and the U.S taxpayer, compared with Fannie or Freddie retaining the credit risk itself?

Importantly, this stress capital-driven approach to assessing alternatives to Fannie and Freddie risk-taking will be valid even if Treasury prevails in the lawsuits, and the companies are not permitted to retain capital. In that case, the government effectively would become the owners of Fannie and Freddie, and instead of having to hold actual equity capital would be deemed to have “notional invested capital” equal to the stress requirement. As “owners” of the companies, the government should want to price Fannie and Freddie’s credit guarantees exactly as shareholders do: so that the fees charged fully compensate for the risks taken (as measured by required stress capital), while yielding an appropriate return on that risk-taking. Similarly, the government only should want to do risk sharing when what it has to pay in cost or give up in guaranty fee is more than offset by what it deems to be a reduction in risk—no different from the motivations of a private shareholder.

For FHFA to implement a borrower benefit standard for Fannie and Freddie’s risk transfer activities, it will need to accomplish four tasks after it updates their capital requirements (and after the companies adjust their guaranty fees to these new requirements). First, FHFA will need to ensure that it clearly understands how each risk sharing mechanism and transaction type the companies potentially could use is structured and functions. Second, it will need to make accurate “all-in” assessments of costs to the borrower and changes in risk to the companies for each alternative. FHFA’s third and most difficult task will be to determine the exact amount of capital relief to grant Fannie and Freddie for each risk-sharing mechanism they use or risk transfer transaction they undertake, so that the companies will know the maximum reduction in guaranty fees they can offer for those forms of risk sharing and still pass their risk-based capital stress tests. Then, FHFA’s final task will be to combine all of the elements of the first three tasks and assess whether the increased costs (either to the borrower or to Fannie and Freddie) and lower guaranty fees associated with each type of risk-transfer mechanism or transaction produce an overall lower cost to the borrower—for equal amounts of risk-taking—compared with the companies keeping that risk themselves.

There are three basic types of risk transfers FHFA will need to be able to evaluate: supplemental private mortgage insurance, lender recourse, and securitized credit risk transfers.

Supplemental private mortgage insurance (MI). Fannie and Freddie’s charters require them to have some amount of private mortgage insurance (or its equivalent) on all mortgages they purchase or guarantee with down payments less than 20 percent. At their election, however, they may require greater levels of MI on these loans (known as “deep cover” MI), which typically will be paid for by the borrower. In addition, Fannie and Freddie may ask mortgage insurers to insure loans after they have been acquired (so-called “back-end” MI), in transactions the companies pay for themselves.

After doing the risk, cost and benefit evaluations discussed above for these MI-related transactions, FHFA also must assess counterparty risk: whether the mortgage insurers Fannie and Freddie use have sufficient equity capital and loss reserves to meet their obligations to the companies. To test that, FHFA should apply the same stress test to all of the MIs used by Fannie and Freddie as it does to the companies themselves. If the MIs do not have sufficient capital to meet Fannie and Freddie’s stress standard, the companies will have to make up any capital shortfalls themselves (to pass their own stress tests). The existence of stress capital shortfalls at any MI will be a red flag for FHFA, meaning not only that voluntary deep cover or back-end arrangements with those MIs will not be economic for Fannie and Freddie but also that they should take steps to limit or reduce their exposures to those capital-deficient companies on the borrower-paid MI required by their charters.

Lender recourse. In these arrangements, a lender agrees to cover a certain percentage of the losses on loans it sells to Fannie or Freddie in exchange for a lower guaranty fee. Lender recourse transactions typically are backed by collateral. FHFA’s job in these cases (in addition to determining the capital credit) will be to ensure that the collateral is of an amount and quality sufficient to cover the risks involved, and that all collateral agreements are properly executed. Should Fannie and Freddie wish to do lender recourse arrangements that are not collateralized, FHFA will need to assess their risks on a case-by-case basis. It generally will not be possible for FHFA to run stress tests on these lenders (most of whom are likely to be large commercial banks), so its assessments of counterparty risk in these cases will be subjective. For this reason, FHFA would be wise to limit uncollateralized lender recourse transactions to some small percentage of Fannie and Freddie’s required capital.

Securitized credit risk transfers. These are, by far, the most challenging types of risk sharing transactions for FHFA to evaluate and regulate. Most securitized credit risk transfer structures are highly complex, with multiple unpredictable elements (including but not limited to mortgage prepayments and the amount, timing and severity of credit losses) interacting to affect the amount of risk actually transferred. For this form of risk sharing, FHFA will have the daunting task of deciding how much capital relief to give Fannie and Freddie on day one for structures whose ultimate value is uncertain, and indeed unknowable until many years in the future.

The experience with Fannie’s Connecticut Avenue Securities (CAS) program shows just how difficult this task will be for FHFA. The two principal risk-bearing tranches of recent CAS deals (called “M-1” and “M-2”) are described as providing protection against credit losses between 1 percent up to 4 percent of the initial balance of the mortgage pools they are issued to protect. Yet the sensitivity analyses in Fannie’s own prospectuses project that the company will transfer no credit risk at all to the buyers of the M-1 CAS tranche, and show that there is only a small chance of transferring risk to buyers of the M-2 CAS tranche. This “intentionally defective” structure of Fannie’s CAS tranches makes them dramatically inferior to equity capital as protection against credit risk—so much so that the only realistic capital credit for FHFA to assign these “risk sharing” securities is something close to zero.

In its request for input, FHFA states that Fannie and Freddie’s credit risk transfer programs “should consist of transactions in which the cost to the Enterprise for transferring the credit risk does not meaningfully exceed the cost to the Enterprise of self-insuring the credit risk being transferred.” Fannie’s CAS program badly fails this test. Fannie has committed itself to make billions of dollars in interest payments to purchasers of CAS risk-sharing securities that will absorb few if any credit losses, even in a stress environment. These deals are clearly, and grossly, uneconomic, and as it reviews its approach to evaluating future credit risk transfers FHFA must ask itself how it could have failed to detect that fact.

The most likely explanation is that FHFA in its role as conservator set fixed goals for risk-sharing transactions for both Fannie and Freddie and then, as regulator, did not pay sufficient attention to how the structures of the CAS deals done by Fannie in response to that FHFA directive affected their economics.

To avoid a recurrence of this problem in the future, FHFA in its role as regulator must not make any type of risk sharing for Fannie or Freddie mandatory (and it should unequivocally oppose any legislative proposals that do). Mandatory risk-sharing renders the forms of economic analysis that are the subject of this request for input moot, since by definition risk sharing that is mandatory will be done whether it makes economic sense or not. Mandatory risk sharing also transfers responsibility for determining what credit risks are insurable to third parties who may not be committed to providing mortgage credit throughout the business cycle, and gives those entities near-monopoly pricing power, to homebuyers’ detriment.

FHFA now is conservator of two companies that for decades have been the gold standard of single-family mortgage credit risk management. Their business model of prudent underwriting, at-risk capital, and unparalleled abilities to diversify credit risk has provided consistent access to low-cost mortgage credit, at loss rates unequalled anywhere else in the industry, to a wide range of borrower types in very large volumes across the business cycle. It is FHFA’s responsibility to reinvigorate this business model by giving it updated capital standards that incorporate the lessons learned from the financial crisis. Then, FHFA should apply the approach and standards detailed above to ensure that any mechanisms or transactions used to transfer credit risk away from Fannie and Freddie are at least as efficient and effective as what the companies can provide through self-insurance, so that neither the cost nor availability of mortgages to homebuyers is affected adversely.

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\*Timothy Howard was chief financial officer of Fannie Mae between 1990 and 2004. Among his responsibilities in that capacity were mortgage performance analysis and the determination of capitalization and guaranty fees for the company’s single-family credit guaranty business. Howard published a book on Fannie Mae and the financial crisis, titled *The Mortgage Wars,* in November 2013, and since February 2016 has offered periodic commentary on mortgage finance-related issues on his website, *Howard on Mortgage Finance.*