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Housing Policy Council President Ed DeMarco Delivers Remarks at FHFA's Listening Session on Credit Risk Transfer

Washington, D.C. – *Ed DeMarco, president of the Housing Policy Council (HPC) participated in the Federal Housing Finance Agency's (FHFA) "Listening Session" today to discuss credit risk transfer. Below is DeMarco's presentation, as prepared for delivery:*

Thank you for this opportunity. I appear today on behalf of the Housing Policy Council (HPC). It is safe to say, however, that my support of the credit risk transfer program goes back to its very beginning.

HPC's formal comment letter includes a lengthy explanation of the value we see in credit risk transfer (CRT) as a critical risk mitigant and as a meaningful source of loss absorption capacity. We include detailed analytics of why we think the proposed rule would render CRT ineffective in the Enterprises' capital management strategy, thereby driving up their cost of capital.

My goal today is not to review the finer points on CRT covered in our letter and, I might add, covered quite well by other commenters, including several we've already heard from this morning such as Arch, Guy Carpenter, and AON. Instead, I want to explain the value of CRT as a source of risk oversight and loss absorption, thereby providing context to why FHFA should rethink its treatment in the capital rule.

Fannie Mae's and Freddie Mac's failures in 2008 resulted from far too little capital and far too much risk. The GSEs acted as if their nationwide portfolio diversified away mortgage credit risk. We learned otherwise. We suffered the consequences of concentrating $5 trillion of mortgage credit risk on two balance sheets.

But here is a key point. It is not just that Fannie and Freddie's capital requirements were too low - although they clearly were. It was that they were allowed to concentrate all that risk on their two balance sheets, and oversight of the risk management from this arrangement was left to their equity investors. Only two risk management teams – one at each company –

concerned themselves with mortgage credit risk. MBS and debt investors, correctly it turns out, perceived they did not bear credit risk and thus did not monitor or price for this risk.

This is what makes the credit risk transfer program essential for the secondary mortgage market going forward. It is not just that FHFA must increase the GSEs' capital requirements to be on par with other regulated entities holding mortgage credit risk. It is that we must diversify those sources of capital and broaden the universe of institutions and investors that serve as bearers of credit risk, organizations that can expand and enhance the monitoring and evaluating of mortgage credit risk so we are not reliant upon the risk management judgments of just two companies.

As our comment letter, and many other comment letters, point out, if implemented as proposed, the capital rule would provide so little capital relief to the Enterprises from CRT, or put another way, make obtaining that capital relief so costly, it would not be used broadly. That would bring us back towards the pre-CRT world where the GSEs retained virtually all the credit risk on the mortgages they securitize.

That produces three things:

1. Enormous systemic risk
2. Few evaluators of credit risk, and
3. Limited market pricing of credit risk.

In contrast, a world in which the Enterprises receive appropriate capital relief from CRT would result in greater scrutiny of mortgage credit risk and much greater dispersion of that risk in the market. Let me highlight three benefits:

1. A considerable reduction in systemic risk because credit risk would be distributed across numerous investors and numerous transactions. If for no other reason than this, FHFA as a prudential regulator and a member of FSOC should find tremendous value in CRT.
2. Each CRT transaction has multiple investors focused on the loans in that pool. By incentivizing or requiring CRT across virtually all pools, as is FHFA's practice today, no pool goes without its own scrutiny. Changes in risk characteristics will be noticed and priced by the market. Examples of this happening were noted in several comment letters. With more eyes evaluating both the level and change in risk, the likelihood of an adverse and systemic outcome from the risk management mistakes by the two GSEs is greatly diminished.
3. By having to go into the market to purchase loss absorption capacity via CRT on every pool, FHFA and the GSEs receive ongoing market feedback on the singular risk that is central to the GSEs' business. And this feedback is far more transparent than when the

risk is warehoused by the GSEs and backed by equity capital that is rarely issued and whose market pricing is affected by many factors.

In the proposed rule, FHFA observed that CRT has less loss absorbing capacity than equity because it is limited to certain risk on certain pools. Fair enough. But that observation does not do justice to the loss absorbing capacity CRT does have for what is the central risk to be managed: mortgage credit risk.

If CRT were randomly executed on just some of the book of business, that could be a concern. However, FHFA set a 2019 scorecard goal for the Enterprises to have CRT cover at least 90 percent of credit risk associated with all newly acquired single-family mortgages in targeted

categories. Since the loans not subject to CRT also are the least risky (like very low LTV loans), CRT covers the vast majority of mortgage credit risk held by the Enterprises, making it functionally capable of covering almost all potential unexpected single-family credit losses.

Moreover, the practice has been, and should remain, that the amount of risk transferred from each pool should well exceed projected severe stress losses. Model risk associated with projecting stress losses – another FHFA concern – is borne mostly by CRT investors, not the GSEs.

Let me address two other concerns FHFA raises about CRT. First, there may be temporary periods, as we saw this spring, when market volatility disrupts the normal functioning of the CRT market. Yes, that can happen. Such resetting of risk assessments when circumstances change is a normal and desirable feature of private markets. Our long history of credit market performance shows such episodes are infrequent and brief and they are why FHFA proposed a stress capital buffer and other buffers. But when market disruptions do arise, the existing CRT is there to absorb losses on the existing business.

Second, FHFA argues that the sum of all tranches, both retained and sold via CRT, should require more capital than the equivalent underlying risk. HPC does not take issue with that principle. However, we object to the excessive and overlapping haircuts and adjustments that collectively treat CRT as an added risk to the Enterprises rather than a risk mitigant.

These adjustments take three forms: a 10 percent risk-weight floor; a series of effectiveness adjustments that includes a 10 percent haircut on all risk transferred, effectively assigning that risk back to the Enterprise; and a set of operational criteria. Of these, the most consequential and least defensible is the fixed 10 percent risk-weight floor.

In the end, the treatment of CRT in the capital framework is not an either/or question. The goal should be to maintain prudent levels of both equity capital and CRT. This would enable the Enterprises to benefit from the unique loss absorbing and risk mitigating features of both.

We believe CRT acts more like permanent capital than FHFA gives it credit for in the proposed rule. A balance between common equity, other capital, and CRT promotes the effective deployment of capital at the most efficient cost and benefits home buyers in the form of lower mortgage rates. Additionally, it fosters a smoother emergence of the Enterprises from conservatorship. Punitive discounting of CRT capital relief disrupts that efficient capital allocation and raises borrowing costs.

Finally, the proposed rule notes FHFA's intention to halt lender-risk share CRT. HPC requests FHFA to reconsider that decision and our letter sets forth our reasons in detail. FHFA's goal should be a deep, liquid, and competitive market for mortgage credit. Limiting market participants limits competition and hinders that outcome.

Thank you.

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About HPC

The Housing Policy Council is a trade association comprised of the leading national mortgage lenders and servicers, mortgage and title insurers, and technology and data companies. HPC advocates for the mortgage and housing marketplace interests of its members in legislative, regulatory, and judicial forums. The association's interest is in the safety and soundness of the housing finance system, the equitable and consistent regulatory treatment of all market participants, and the promotion of lending practices that create sustainable homeownership opportunities in support of vibrant communities and long-term wealth-building for families.

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