December 7, 2015

The Honorable Richard Shelby
Chairman, Senate Committee on Banking, Housing, and Urban Affairs
Washington, DC 20510

The Honorable Jeb Hensarling
Chairman, House Committee on Financial Services
Washington, DC 20515

The Honorable Sherrod Brown
Ranking Member, Senate Committee on Banking, Housing, and Urban Affairs
Washington, DC 20510

The Honorable Maxine Waters
Ranking Member, House Committee on Financial Services
Washington, DC 20515

Dear Members of Congress,

On behalf of its diverse membership, SIFMA[1] writes to applaud the bipartisan interest shown by many in Congress in strengthening the Federal Housing Finance Agency's ("FHFA") efforts to implement private-sector credit risk transfer transactions ("CRT") involving Fannie Mae and Freddie Mac ("GSEs"). SIFMA and its member firms strongly support Congress in your effort to restore significant levels of private capital participation in the extension of mortgage credit. Like many stakeholders, our industry seeks a mortgage market that balances access to credit with systemic stability and prudent underwriting.

Among other developments, SIFMA and its members took note of the June 10, 2015 letter led by Senators Warner and Corker to FHFA Director Watt stating that "credit risk transfers are a vehicle for moving the housing market forward by attracting private sector investments, improving access to credit, and reducing taxpayer risk".[2] CRT is now the primary vehicle through which investors in non-agency mortgage products can provide their capital to the market, aside from purchasing whole loans, given the dearth of new issuance in the non-agency mortgage-backed securities market. CRT provides investors with exposure to mortgage credit risk at a reasonable rate of return and moves that risk away from taxpayers who already shoulder too much of the risk.

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[1] SIFMA is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose 889,000 employees provide access to the capital markets, raising over $2.4 trillion for businesses and municipalities in the U.S., serving clients with over $16 trillion in assets and managing more than $62 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] http://www.warner.senate.gov/public/index.cfm/pressreleases?ContentRecord_id=2c4bb722-d97b-43b2-bec4-4c0c993fee0d

While SIFMA is a strong supporter of the GSE's CRT transaction programs, we believe there are opportunities to deepen CRT liquidity and a clear and present role for policymakers to improve the conditions for CRT. SIFMA believes there is a role for both upfront and back-end risk sharing. Today's letter is a summary of our views regarding the most significant impediments to greater liquidity and investor interest in CRT, including specific recommendations that could enhance FHFA's efforts in the near term. SIFMA looks forward to working collaboratively with Congress, FHFA, and other stakeholders to enhance these important programs.

Sincerely,

Christopher Killian
Managing Director
Head of Securitization

David Oxner
Managing Director
Federal Government Relations

cc: Senate Committee on Banking, Housing, and Urban Affairs and House Committee on Financial Services

A. Upfront CRT

While we agree with the need for a period of experimentation and continual refinement, we believe that over time structures need to coalesce and be directed towards the most scalable and programmatic forms of issuance to promote maximum liquidity. Encouraging diverse but scalable transactions is essential to deepen the overall pool of private capital willing to transfer risk away from taxpayers and the GSEs. "Upfront" risk sharing could make housing finance more efficient and sustainable by allowing the GSEs to achieve day-one risk transfers without having to warehouse credit risk until it can be distributed in a back-end credit transfer transaction. Upfront risk sharing can also provide strong incentives to the issuing originator to deliver quality loans to the GSEs and private investors since any improvements in pricing, relative to the GSEs and based (in part) on the originator's loan quality and historical performance, could be used to provide a benefit to customers and expand access to mortgage credit. We note that transactions executed so far have not included an explicit retention of risk (e.g. holding securities issued in the deal) by the GSEs. As is the case with back-end CRT, investors would be encouraged to invest in these transactions if the GSEs retained a portion of the credit risk to ensure the proper alignment of interest between the GSEs and investors. FHFA and the GSEs can help promote affordable lending by both large and small lenders and can be structured to substantially reduce or eliminate counterparty risk to the GSEs or any successor guarantor. Moreover, day-one credit risk transfer structures designed to cover actual losses could help to mitigate the risk of loss to tax payers through a transition to a non-GSE dependent housing finance system. Lastly, we believe these transactions could be used to evaluate and further develop credit risk sharing alternatives for potential use by the Common Securitization Platform.

B. Back-End CRT -- Legal & Regulatory Impediments

1. REIT Eligibility

Mortgage real estate investment trusts ("REITs") are important participants in agency and non-agency MBS markets, and have grown significantly since the mid-2000s, but remain limited participants in the CRT markets. According to FHFA, REITs make up 2% of the CRT investor base.[3] Their participation in the markets for CRT is limited due to restrictions in the Investment Company Act of 1940 and the Internal Revenue Code that govern what are eligible investments for REITs. All forms of CRT (including front-end CRT) should be fully REIT-eligible assets given their core nature as investments in residential mortgage credit, and mortgage REITs' important position as capital markets investors.

2. Capital Requirements and NAIC Evaluations

As intermediaries, banks and broker dealers play a critical role in making markets and supporting the secondary trading of securities for capital market issuers and investors. Bank and broker dealers have capital requirements that are higher now than they were in the past. While this increase in

[3] See http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Overview-8-21-2015.pdf, at 14.

capital is an important component of strengthening our banking system and increasing financial stability, at the granular level the capital treatment of CRT transactions creates a significant impediment to the participation of banks and broker dealers as market makers for CRT. The higher capital requirements effectively remove banks from the investor base for these transactions and make market making more capital-intensive than it needs to be. Almost all bonds issued to date attract a dollar-for-dollar capital charge (or more) for US banks who use the SSFA formula for calculating capital. Additionally, the Basel Committee is currently undertaking a review of its so-called "trading book" capital requirements that apply to banks' market making activities.[4] Based on industry analysis of data submitted to bank regulators, capital requirements for securitized products would more than double under the proposed requirements, and we expect capital requirements would also increase for CRT transactions. This, on top of other capital requirements, would serve to further decrease liquidity in this sector.

The National Association of Insurance Commissioners ("NAIC") provides a service that evaluates residential and commercial mortgage-backed securities.[5] These evaluations are used by state insurance regulators to determine risk-based capital requirements for holdings of regulated insurance companies. However, most CRT securities are not NAIC evaluated, or the results of the NAIC evaluations are harsher than the prevailing market view of the risk of the securities. Since most of the securities have low or no NAIC evaluations and concomitant higher capital charges, insurance companies are not as active in this market as they otherwise would be. SIFMA encourages NAIC to include all CRTs in their annual evaluation to help support this important and emerging asset class and ensure evaluation results are in-line with the true risk of the securities.

3. Commodity Pool Regulation

The current Connecticut Avenue Securitization ("CAS") and Structured Agency Credit Risk ("STACR") structures are non-guaranteed corporate debt of the GSEs – the nature of the issuance as 'debt' implicates concentration limits for some investors since they are limited in their allowable exposure to particular issuers.

The most efficient form of CRT that has been proposed involves the use of credit-linked notes ("CLN") to transfer risk from the GSEs to private investors. However, structures that use CLN would be considered "commodity pools" under the CTFC's rules, and bring with them various burdensome reporting and registration requirements. The CFTC has provided some limited relief from commodity pool status[6], but it does not provide all of the relief that is needed.

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[4] See letter from SIFMA and six other groups to banking regulators, discussing the negative impact of the proposed revision to trading book capital requirements, and the need for significant amendment of the proposal, available here: http://www.sifma.org/comment-letters/2015/sifma-and-other-associations-submit-comments-to-bank-regulators-on-the-frtb/.

[5] As described by NAIC: *"In 2009 members of the National Association of Insurance Commissioners (NAIC) approved the recommendation of the Valuation of Securities (E) Task Force and Financial Condition (E) Committee to create a new modeling and assessment process for non-agency residential mortgage-backed securities (RMBS). This assessment process will assist state regulators in ultimately determining the Risk Based Capital (RBC) requirements for the non-agency RMBS/CMBS owned by U.S. insurers at the end of each year. For each of the RMBS/CMBS CUSIPs, the new model will produce prices based upon expected losses for each NAIC designation. Insurers will map the carrying value of each RMBS to these amounts to determine the appropriate NAIC designation and accompanying RBC requirements".* Available here: http://www.naic.org/structured_securities/documents/STS_user_guide.pdf

[6] See CFTC Letter 14-111, available here: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-111.pdf

The current relief from the CFTC related to the status of CLN structures as commodity pools is limited to a specific synthetic structure and relates to whether or not the GSEs would need to register as commodity pool operators when they issue the CLN transactions. The relief maintains that the GSEs would not have to register as a commodity pool operator if they issued CLNs structured in accord with their relief letter.

However, the relief does not provide that the CLN structures themselves are not commodity pools which may cause problems for banks under the Volcker Rule as they may be considered covered funds.[7] Additionally, there is a lingering fund-of-funds question—i.e., that the investors in the CLN structure will need to treat their investments as investments in a commodity pool for purposes of their fund-of-funds analysis. The CFTC should issue a determination that these transactions are not commodity pools.[8]

4. Dodd Frank §621

The SEC's proposed rules to implement DFA §621 (Conflicts of Interest Relating to Certain Securitizations - 15 U.S. Code § 77z–2a) would render impermissible synthetic transactions such as those proposed to be done as more efficient CRT transactions. The SEC's proposed rule specifically prohibits synthetic transactions where a securitization participant enters into a credit default swap to offset such participant's long exposure in the assets underlying the reference pool. This is exactly what some forms of synthetic CRT would do, and is exactly what the securities-based CRTs issued today do in a different, less efficient format. The impact of this proposed rule, if it were finalized without change, is unclear for STACR/CAS structures and requires further legal analysis. CRT in any form should be exempt from these prohibitions under the final rules.

C. <u>Back-End CRT -- Program Design and Other Issues</u>

1. Disclosure

While the GSEs have disclosed large datasets at the loan-level, this disclosure of loan-level information has been limited in certain important ways because of concerns regarding privacy laws. Today's network of connected databases of loan information, public records, and other information makes it far easier to determine specific information about an individual borrower than it has been in the past. Due to these concerns, the GSEs limit the disclosure of key information such as zip codes – in this case, only the first three digits are published (which is essentially county-level). An investor's ability to model transactions is limited because using county-level data does not provide the same ability to model local economic data and home price indices. Investors believe this granular analysis is very important in their analysis of credit risk. The private-label RMBS market has found a way to provide all five digits for new-issue non-agency RMBS and we encourage the GSEs to

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[7] The Volcker Rule includes strict limits on bank holdings of covered funds.

[8] This also applies to characterization of securitizations as commodity pools more broadly – they are also not commodity pools but must deal with various no-action letters that provide incomplete solutions.

develop similar means to provide more robust data required by many investors in residential mortgage credit risk.[9]

2. Demand Can Exceed Supply; Selling More of the Capital Structure

In spite of the issues with capital requirements described in section B.2., many of the existing transactions were oversubscribed at issuance, which indicates that demand was greater than supply of the bonds. At times, larger issuances would aid secondary market liquidity for the product. We believe the GSEs could be more sensitive to market demand and increase the size of offerings to the extent investors supported it. Furthermore, we believe there is an opportunity for GSEs to share more risk through selling securities at more senior levels in the capital structure.

3. Homogeneity

It would be beneficial to liquidity if STACR and CAS structures were more aligned. Investor analysis and market making would be eased, and liquidity should improve. We note that the GSEs are currently working to align the structure of their single-family MBS issuances, and that a similar theoretical principal that homogeneity improves liquidity is applicable here.

For example, STACR's $250k minimum size requirement (compared to $10k in CAS) pushes some investors into CAS and away from STACR; this may be an early opportunity for alignment. On the other hand securities issued in the CAS program are limited to qualified institutional buyers, which may have the opposite effect. These are areas that could be aligned.

D. Uncertainty Regarding GSE Reform and the Future

Market participants have expressed two general concerns about the unknown future of the GSEs. First, there is concern that some portion of the CRT debt issued by the GSEs will be assumed by a private entity lacking the expertise or resources to manage the underlying pools on behalf of investors. Market participants generally expect that all of the GSEs' guaranteed issuances will be assumed or otherwise guaranteed by the government, but CRT transactions are not GSE-guaranteed MBS or GSE-guaranteed corporate debt. The lack of a guarantee when coupled with the unknown futures of the GSEs creates a concern regarding the capitalization of the future entities that replace the GSEs, and how it will be assured that appropriate funding will be available to perform all of the duties of the current GSEs under their CRT programs (e.g., loss mitigation efforts).

Note that this does not mean investors expect the CRTs themselves to become government guaranteed – rather it means investors expect the future entities to be able to service the CRT issuances in accord with their commitments at origination and absorb any losses unrelated to the contractually defined credit risk, so as to avoid any post-facto changes in the risk profile of these investments. For example, if losses result from mistakes in underwriting, errant servicing practices or outright fraud, CRT investors will expect the future entities (or the government) to be able to absorb these losses, even if on temporary basis until originators are forced to honor their own representations and warranties. Future entities should therefore have the necessary capital and

[9] In part with this standard agreement, which we understand the GSEs use a variant of, but still do not disclose five digits: http://www.sifma.org/services/standard-forms-and-documentation/securitized-products/model-asset-level-disclosure-click-through-agreement/

liquidity resources to meet the contractual commitment made in the CRT to remove defective loans from reference pools.

A related concern is that the CRT programs currently sponsored by the GSEs would not be continued in the future, or would be changed in a dramatic fashion that makes them a significantly different product. Investors have a general interest, in any securities market, in knowing that they can count on continued robust issuance of a product. While it seems apparent that private-sector risk sharing will be a part of any GSE reform effort, it is not clear specifically what form this risk sharing will take or at what volume of issuance. This general uncertainty serves to limit liquidity since investors are reluctant to participate without additional guidance and certainty about these programs.

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