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HPC
HOUSING POLICY COUNCIL

April 25, 2022

Sandra L. Thompson
Acting Director
Federal Housing Finance Agency
400 Seventh Street, SW
Washington, DC 20219

Re: Re-Proposal to Enhance Eligibility Requirements for Enterprise Single-Family Seller/Servicers

Dear Acting Director Thompson:

The Housing Policy Council ("HPC")[1] appreciates the opportunity to comment on the Federal Housing Finance Agency's ("FHFA") re-proposal of minimum financial eligibility requirements for Fannie Mae and Freddie Mac (the "Enterprises" or "GSEs") seller/servicers.[2]

HPC supports the minimum net worth and liquidity requirements proposed by FHFA. However, we believe that this framework should be refined to recognize that well-managed nonbank seller/servicers maintain capital and liquidity levels with risk mitigation measures that the GSE standards should encourage and reinforce.

Therefore, our proposed refinements advance commonly used risk management practices that would calibrate the capital and liquidity requirements for seller/servicers to be sufficient for periods of stress. Specifically, we recommend that:

- A portion of committed and available credit lines count toward the liquidity requirements;
- The origination liquidity requirement recognizes netting arrangements as well offsetting TBA or other hedge positions; and
- The definition of net worth aligns with current practices at Ginnie Mae and the GSEs.

Additionally, there are certain features of the re-proposal that require additional consideration, detail, or greater transparency. Specifically, we urge FHFA to:

- Describe how and under what circumstances the liquidity buffers may be accessed;
- Clarify how the third-party assessments of creditworthiness will be implemented;
- Extend the effective date of the re-proposal to avoid undue market disruptions; and

[1] HPC is a trade association comprised of the nation's leading mortgage lenders, servicers, mortgage insurers, and title and data companies. HPC advocates for the mortgage and housing finance interests of its members in legislative, regulatory, and judicial forums. Our interest is in the safety and soundness of the housing finance system, the equitable and consistent regulatory treatment of all market participants, and the promoting of lending practices that create sustainable home ownership opportunities leading to long-term wealth-building and community-building for families.

[2] Re-Proposal to Enhance Eligibility Requirements for Single-Family Seller/Servicers, February 24, 2022

- Determine that operating subsidiaries of banks that are part of a holding company structure be treated as banks for purposes of the eligibility requirements.

Our comments on the re-proposal are divided into four sections. In Section I, we provide some general observations upon which our comments and recommendations are based. In Section II we present and explain our recommended refinements to the re-proposal. Section III discusses those features of the re-proposal that require additional detail or more transparency. Section IV is a conclusion.

I. General Observations

Counterparty risk management is critical to the health and well-being of the housing market. In the case of bank seller/servicers, counterparty risk is addressed, in part, through extensive prudential standards imposed by bank regulators. FHFA's proposed net worth and liquidity requirements represent an analogous set of standards for nonbank seller/servicers that are counterparties to the Enterprises. However, since FHFA is not the prudential regulator of these nonbank seller/servicers, the standards must be tailored to reflect that the Enterprises will implement them through their Selling and Servicing Guides. These will be counterparty standards that the Enterprises will manage as part of their business operations.

Bank regulators have tailored prudential standards for banks according to the size and complexity of a bank. FHFA has proposed a similar approach for nonbank seller/servicers, recognizing the wide array of sizes and complexity among nonbank seller/servicers. The proposal addresses these differences by setting minimum standards for stability and adding requirements for large seller/servicers.

We believe that the re-proposal should be fine-tuned to encourage the continued use of existing liquidity risk management practices. Our proposed refinements do not focus on the percentage requirements for capital and liquidity, but on how those requirements are satisfied. Most importantly, HPC members believe that available capacity under committed lines of credit should receive consideration as a source of liquidity based on the terms of these lines. This may require additional reporting though the Mortgage Bankers' Financial Reporting Form.

We believe our proposed refinements are consistent with FHFA's goals, aligned with prudent business practices, and would promote necessary market stability in times of stress. Whatever the new requirements turn out to be, a well-managed nonbank seller/servicer will want to exceed the final net worth and liquidity requirements by a healthy margin to avoid failing any of these requirements. FHFA calibrated the proposed requirements based upon past stressful events. As a result, nonbank seller/servicers will be assured to have not only the capital and liquidity necessary to have managed those past events, but also, practically speaking, to operate with even higher levels of capital and liquidity as added buffers above the minimums.

II. Recommended Changes to the Re-Proposal

<u>A. Committed and Available Credit Lines Should be Permitted to Meet Liquidity Requirements</u>

Commercial banks face rigorous liquidity requirements, and it is reasonable for FHFA to expect that nonbank seller/servicers that are Enterprise counterparties also meet appropriate liquidity standards. The liquidity requirements for nonbank seller/servicers should reflect the commercial options available to meet the organization's origination, servicing, and operational obligations even in times of severe market illiquidity.

As a general matter, nonbank seller/servicers have three broad liquidity sources available:

1. Cash and cash equivalents held on balance sheet;
2. Liquidity commitments and resources available from a corporate parent; and
3. Lines of credit from commercial banks or other finance companies, often collateralized by the seller/servicers' assets.

Cash and cash equivalents are the surest source of liquidity and appropriately form the foundation of any prudent liquidity plan. However, since such assets have little economic return, a prudent corporate treasurer will hold a certain amount of cash for short-term risk-adjusted needs and will deploy excess cash to short-term investments or to deleverage lines of credit. A prudent treasurer also will source other liquidity backstops to ensure there is adequate long-term liquidity to manage both normal and stressful environments.

Some nonbank seller/servicers are owned by larger corporate organizations with liquidity sources that can be pledged or committed to the seller/servicer. [3] Also, some banks organize their mortgage operations within a subsidiary of the bank, not the bank itself. Since bank holding companies are required to provide financial support to their subsidiaries, HPC requests that FHFA determine that such subsidiaries would be treated as a bank for purposes of this proposal (see Attachment A for greater detail). Generally speaking, entities under consolidated supervision are treated as banks. All these liquidity options must be evaluated against a set of standards that ensures their availability in times of stress and are reasonable for the Enterprises to oversee as part of their counterparty risk management activities.

Access to credit markets can to an extent serve as a commercial alternative to holding liquid assets. Typically, commercial banks or finance companies provide lines of credit that allow a nonbank seller/servicer to borrow funds to support ongoing business operations. In the case of asset-based lending agreements, collateral is pledged to the lender as security for the financing and the value of the collateral is subject to a "haircut," which varies based on the characteristics of the collateral and the nature of the risk. The line of credit provides financing to the nonbank seller/servicer that may be drawn on as needed. The amount of activity that may be financed on these lines of credit will vary based on increases or decreases in the business activity of the seller/servicer as well as the volume and value of the collateral.

A key concern with the re-proposal is that the substantially increased liquidity requirements are imposed without recognition of the notable March 2021 changes to the GSE Selling and Servicing Guides. Those adjustments, in tandem with this re-proposal, exclude unused/available portions of committed lines of credit from counting as liquidity available to meet the new, heightened requirements. This exclusion does not recognize the use of committed liquidity sources as a common liquidity risk management practice. Without giving due consideration to these liquidity sources, the re-

[3] The liquidity information currently provided to the Enterprises by large nonbanks reflects and highlights these additional resources.

proposal could result in an overly conservative increase in required cash and equivalents, an economic cost to nonbank seller/servicers.

Committed lines are subject to contracts that set forth the borrowing terms and include covenants that establish the nonbank seller/servicers' responsibilities to maintain capital, liquidity, and other performance obligations. Nonbanks pay fees to lenders to have these secured lines, a fee which depends, among other things, on the financial profile and performance of the nonbank seller/servicer and the type of collateralized assets.

Commercial banks are required to hold liquidity, capital, and reserves against their outstanding commitments and must report these commitments to regulators as part of their capital and stress testing framework. A bank will honor a commitment, subject to the contractual terms and covenants set forth in the legal agreements. Given these factors, HPC urges FHFA to count a portion of a seller/servicers' committed but unused/available credit lines toward the proposed liquidity requirements, taking into consideration the contractual terms governing the commitment and how they are maintained in stressful scenarios.

Nonbanks also may have uncommitted capacity (either collateralized or not). For such lines of credit, the lender has the right to decide to allow or disallow the funding. For this reason, HPC agrees that uncommitted lines, whether asset-based or not, should not count as available liquidity even though they could reasonably be part of a nonbank's liquidity management program.

Description of Committed Lines of Credit

Not all lines of credit are the same. In simple terms, there are two categories of *committed* lines – asset-based credit lines and credit lines that are not asset-based. Obtaining a committed line of credit, whether collateralized or not, requires demonstrable counterparty strength. The lender will carefully review the operations and financial soundness of the nonbank seller/servicer. For purposes of the liquidity requirements in the re-proposal, we recommend that only *committed* lines count toward the requirements, whether asset-based or not asset-based.

Asset-based lines of credit provide financing at levels that reflect the value and volume of the assets pledged, which will vary over the term of the line. The capacity on the line is the lesser of the contractual limit of the commitment or the value of pledged assets reduced by the applicable haircut and the amount already drawn on the line. Based on the terms of the committed line, this amount is immediately available liquidity.

Asset-based lines of credit may be based upon existing or future collateral. In a committed collateralized line, the pledged assets may include Mortgage Servicing Rights (MSRs), Loans, Early Buyouts (EBOs), and Servicing Advances. The bank or finance company will evaluate the collateral quality and place a limit (haircut) on how much of the asset value it is willing to lend against. The haircut will vary based on the credit risk and price volatility of the asset, covenants, duration, and market conditions.

Creditors recognize variations in risk across different asset types. For example, MSR values are more volatile than servicing advances. MSRs are subject to mark-to-market adjustments in value that may move significantly during times of economic disruption. As a result, MSRs are subject to larger haircuts than other assets typically pledged. In contrast, a servicing advance is an account receivable from a government agency or a GSE and thus is not subject to the price volatility or credit uncertainty of MSRs, even in stressful environments.

HPC recognizes that FHFA is concerned with the resiliency of lines of credit in times of severe stress. HPC also recognizes that lenders extending committed lines of credit take precautions to protect themselves, including the covenants and other contractual terms governing a particular credit line. It should also be noted that the Enterprises themselves influence the reliability of certain assets as collateral. In particular, the ability of the Enterprises to seize and transfer MSRs affects how lenders perceive lending against that asset. Despite these limitations, MSRs are used as collateral on committed lines of credit and thus warrant consideration by FHFA in determining available liquidity.

Once accounting for the reliability of the commitment and the quality of the asset, the undrawn available capacity of asset-based committed lines should count towards immediate liquidity because the conditions required to draw these funds have been met and cannot be repealed. All things being equal, that capacity will increase (decrease) as the collateral values increase (decrease).

Available capacity on a committed asset-based line also changes as assets change. For example, if delinquencies require new servicing advances, the servicer could pledge those advances receivables and draw on the credit line to receive cash. This arrangement serves as a risk mitigant if the committed liquidity is available for an appropriate period of time, as the need (e.g., new servicing advances receivables) materializes. That feature means that committed servicing advance lines prepare a servicer with the financing needed to fund future advances if mortgage delinquencies rise. This aligns well with FHFA's proposed base liquidity standard, which is a function of the type of mortgage and the remittance schedule (riskier mortgages and mortgages with heightened advancing requirements face a higher base liquidity charge.)

In contrast to an asset-based credit line, non-asset-based lines do not require a pledge of assets to serve as security for the financing. These lines are underwritten on the general credit worthiness of the institution or are based on a guarantee by a parent or related company. Covenants in the credit line agreement govern the terms and conditions of lending and the undrawn portion of such committed lines may be drawn at any time subject to those terms.

In summary, a committed line of credit is available to be drawn as needed and may not be withheld so long as the terms of the contract are satisfied. As already noted, the amount of credit available is set in the contract and limited by the volume and value (with haircut) of the pledged collateral.

Excluding committed but unused credit lines as part of a servicer's liquidity resources effectively discourages the prudent practice of prepositioning liquidity sources before such sources are needed. By excluding these lines as liquidity resources, nonbank seller/servicers will need to weigh drawing on such lines when not needed or foregoing the expense of such commitments altogether. In certain economic cycles, it is far more economically advantageous for a nonbank to maintain a lower draw on these lines than to deploy the cash in deposits or other eligible short-term instruments. In fact, drawing on a line of credit just to create cash on a balance sheet, rather than waiting to draw when needed, increases the nonbank seller/servicer's balance sheet and their leverage.

Committed Lines of Credit Align Incentives Across Servicers, Lenders, and the GSEs

An important characteristic of financial regulation is incentive alignment. Regulators often rely on an alignment of interest between parties to design rules that provide complementary enforcement. In financial services, regulations often leverage counterparty relationships and agreements to motivate prudent risk management practices by regulated entities. HPC believes that recognizing some portion of committed lines of credit for purposes of nonbank seller/servicers liquidity requirements aligns incentives for the nonbanks, lenders, and the Enterprises.

To be clear, HPC is not saying that banks and other institutions that extend credit lines to nonbank seller/servicers assume any regulatory responsibility over those nonbanks. The point is simply that the lenders' financial interests in the integrity of the arrangement align with those of the Enterprises.

A commercial bank or finance company with a contractual commitment to advance funds to a nonbank seller/servicer has direct exposure to that nonbank's capital adequacy and liquidity risk management. Thus, the lender will carefully examine the financial condition, financial risk management practices, and asset quality of the nonbank in setting the terms of any line of credit commitment. That is, the lender will assess its counterparty risk under the commitment. The lender also will price that risk accordingly, making the commitment more expensive for a riskier counterparty or a riskier set of assets. In sum, the lender has a direct interest in the condition of the nonbank seller/servicer. Moreover, the lender will continually monitor the performance of the nonbank seller/servicer, which provides an extra layer of oversight throughout the term of the commitment that complements oversight by the Enterprises.

Contract terms will include covenants that specify the responsibility of the nonbank seller/servicer to remain in good standing. Covenants may relate to the net worth and liquidity position of the firm and a breach of such covenants may trigger financial penalties. Often, such covenants are written to align with regulatory requirements, such as liquidity or net worth requirements that Ginnie Mae or the Enterprises or a state regulator may impose. Importantly, historic experience shows that covenant violations have seldom resulted in a curtailment of the line. Instead, violations made it harder for nonbank seller/servicers to renew the line on the same terms and may result in other financial penalties. This approach to managing and pricing for risk is basic market discipline and it aligns with the interests of the Enterprises.

Banking Regulations Address the Risk of Credit Lines

The Federal banking agencies have issued regulations that address the reliability of credit lines. These regulations include a requirement that a bank hold capital against the unused portion of a committed credit line,[4] a requirement that a bank reserve for potential losses related to a credit line,[5]

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[4] Under current risk-based capital requirements, a bank must hold capital against off-balance sheet items based upon a credit conversion factor of either 20 percent or 50 percent depending on the maturity of the credit line and the bank's ability to cancel the credit line. See 12 C.F.R. § 324.33.

[5] Under the Current Expected Credit Losses (CECL) accounting standard, banks must estimate expected losses over the life of the facility and then hold a reserve against the expected losses. See ASU 1016-3 and FAQ No. 9 on CECL issued by the federal banking agencies

and a requirement that a bank have sufficient liquid assets to fund the unused portion of a credit line over a 30-day period.[6]

Collectively, these regulations encourage a bank to carefully manage its counterparty risk exposure when extending a line of credit and to have the capacity to fulfill its obligation under the line of credit even in stressful market conditions.

This regulatory framework does not dictate how an individual bank will act with respect to a given counterparty in all circumstances. Rather, it reflects a bank regulatory regime designed around the premise that banks themselves should have sufficient capital and liquidity, even under stress, to honor their commitments to extend credit when contractual conditions have been met.

Furthermore, in times of economic stress or market volatility, the Federal Reserve Board may liberalize cash availability to the banking system so banks can provide needed liquidity to other market participants. Committed lines of credit provided by banks are a pre-arranged vehicle for fulfilling this outcome.[7] Therefore, HPC believes that counting committed but unused credit lines toward the liquidity requirements for nonbanks is consistent with the goal of federal banking regulations.

Studies on the Availability of Credit Facilities in Periods of Stress

Studies demonstrate that credit facilities can be a reliable source of liquidity, even in periods of economic stress.[8] One study by Federal Reserve Board economists found that the availability of credit facilities for nonfinancial businesses was not significantly reduced on average from 2007 to 2009 (from 90 percent to 86 percent).[9] Another study by Moody's Analytics of 2002-2011 found that approximately six percent of firms with a line of credit were in violation of a credit line covenant each year, and this frequency did not increase significantly during the financial crisis.[10] Yet, this study found that less than one in five violations resulted in a total or partial cancellation of the credit line. Instead, the most common way for banks to restrict access to credit lines was by tightening the terms of the contract when the commitment renewed, using interest rate increases, new haircuts on asset pledges, and shorter maturities on the credit line.

[6] Federal regulations assume different percentage outflow amounts on credit lines over a 30-day period depending on the counter party and the purpose of the line (i.e., operational purpose of liquidity purpose). See 12 C.F.R. § 249.32.

[7] Viral Acharya, Heitor Almeida, Filippo Ippolito and Ander Perez, *Bank Lines of Credit as Contingent Liquidity: A Study of Covenant Violations and Their Implications*, Working Paper Series No. 1702, European Central Bank, August 2014 ("Our paper highlights the importance of the liquidity insurance provided by banks through credit lines for the real economy, especially in times of low aggregate liquidity.")

[8] Daniel L. Greenwald, John Krainer, and Pascal Paul. 2021, *The Credit Line Channel,* Federal Reserve Bank of San Francisco Working Paper 2020-26, November 2021. https://doi.org/10.24148/wp2020-26

[9] Jose M. Berrospide and Ralf R. Meisenzahl, *The Real Effects of Credit Line Drawdowns*, Finance and Economic Discussion Series 2015-007, Board of Governors of the Federal Reserve System, February 2015.

[10] Dr. Janet Zhao and Lucia Yang, *Usage and Exposures at Default of Corporate Credit Lines – An Empirical Study*, Moody's Analytics, September 2019.

A recent Federal Reserve Board research note describes the trend since the 2014 establishment of the bank liquidity coverage ratio (LCR) for bank credit lines to replace liquid assets for nonbank financial institutions.[11]

Collectively, these studies lend support for FHFA to include some of the unused portion of committed credit facilities as counting toward the liquidity requirement for nonbank mortgage seller/servicers.

Committed Credit Lines Performed in Spring 2020

The early weeks of the COVID-19 national emergency presented system-wide uncertainty.[12] The broad economic shutdown combined with a legislated mandate that seller/servicers grant borrowers up to 12 months of payment forbearance introduced a unique liquidity demand. The system-wide need for liquidity was particularly acute for nonbank seller/servicers that manage the bulk of the affected mortgages.[13]

Initial alarm that this situation could create an untenable liquidity squeeze subsided when a confluence of factors averted meaningful liquidity stress among nonbank seller/servicers. Of note, actions by the Federal Reserve generated an unexpected volume of lending activity, which helped to avert a significant stress event. In this environment, HPC's nonbank seller/servicer members found that their committed liquidity lines performed as expected and they were able to draw on them during this period. All seven of HPC's nonbank seller/servicers report that they maintained and were able to *expand* their committed lines of credit in the spring of 2020. Similarly, HPC bank members report honoring all such committed lines except when the seller/servicer lacked the required collateral (a circumstance limited to advance lines of certain smaller nonbank seller/servicers).

Market observations and research also found the same result. For example, a researcher at the Federal Reserve Bank of Cleveland noted that "There was also relatively little action in terms of cancellation of warehouse lines of credit.[14] In this same article, the author notes that some outside observers had been concerned that banks "could potentially shut off these lines of credit" in the event of a systemic crisis but that did not happen.[15] Importantly, the author also acknowledges the important distinction between committed and uncommitted lines of credit, noting that "… the contractual ability of banks to shut off lines of credit varies by the type of credit line, specifically whether the line is committed or uncommitted. An uncommitted line can be rescinded, while a committed line is a legally binding agreement to lend."[16]

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[11] Vladimir Yankov, *The Liquidity Coverage Ratio and Corporate Liquidity Management,* FEDS Notes, February 26, 2020, p. 1.
[12] As one example, Federal Reserve actions resulted in TBA prices disconnecting from their normal relationship to interest rate movements.
[13] Part of the liquidity uncertainty during this time resulted from inconsistencies in and uncertainty about how the two Enterprises treated servicer advances on forbearance. FHFA itself resolved that liquidity stress by limiting advancing obligations to four months, a decision that removes this uncertainty for future events that result in widespread mortgage forbearance.
[14] Lara Lowenstein, "Why Wasn't there a Nonbank Mortgage Servicer Liquidity Crisis?" Economic Commentary, Federal Reserve Bank of Cleveland, Number 2021-15, July 1, 2021, p. 6.
[15] Id, p. 2.
[16] Id, footnote 2.

While the Spring 2020 period threatened but did not produce a liquidity crisis, it does provide certain lessons. For one, committed lines proved reliable in this period. For another, when unprecedented conditions induce legislative or regulatory changes that add new expectations and responsibilities for seller/servicers, market stability would be enhanced by including complementary rule changes or liquidity provision to the system. HPC's statement on system liquidity in April 2020 made this point.[17] As it turned out, program changes at the Enterprises, Ginnie Mae, FHA, and other agencies, the Federal Reserve's broad interventions to support financial market liquidity, and the actual take-up rate on forbearance together enabled seller/ servicers to carry out their responsibilities despite the unprecedented legal mandate of mortgage payment forbearance.

FHFA Should Consider Committed but Unused Lines of Credit

Rather than excluding unused but committed lines of credit entirely, HPC recommends that FHFA count a reasonable percentage of the available capacity of committed lines of credit toward the liquidity requirements. For all the foregoing reasons, such lines are an important component, but not chief source, of a nonbank's liquidity resources. Therefore, we strongly recommend that FHFA consider ways to recognize the role committed lines play as part of a prudent liquidity risk management framework.

A variety of approaches are possible for counting the available capacity on committed lines of credit toward the proposed liquidity requirements. On the assumption that simpler is better, HPC proposes that FHFA count available capacity on committed lines of credit subject to the following conditions:

1. Committed lines should count up to a capped percent of a nonbank seller/servicer's overall liquidity requirement. For example, the cap could be aligned with the banking regulators' liquidity coverage ratio, which counts Level 1 assets without limit while level 2A and 2B assets may not count for more than 40 percent of the overall liquidity requirement. Taking this approach, committed lines would be analogous to level 2A and level 2B assets, depending on the type of line.[18] In this way, nonbank seller/servicers would receive limited liquidity credit for assets on their balance sheets that are pledged to committed asset-based lines of credit. Just as bank rules distinguish level 2A and level 2B assets based on haircuts assigned, FHFA could consider available capacity under warehouse lines and servicing advance lines differently than MSR-backed lines.

2. The amount of such lines counting as liquidity could be further reduced as a committed line approaches its renewal date. Since fees are paid when renewing a line, seller/servicers typically renew close to a line's maturity date to avoid double payment of fees but the maturity date also poses an option for the lender not to renew. To balance these considerations, one approach would be to reduce the amount of such lines counting as liquidity by 25 percent at 60 days before renewal and 50 percent at 30 days before renewal.

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[17] *Understanding Liquidity Needs in Mortgage Servicing*, Statement of HPC President Edward DeMarco, April 17 2020.
[18] See 12 C.F.R. 249.21.

3. Nonbanks should be required to report covenant breaches to the Enterprises that result in any penalty or other alteration to the terms of the credit line. The Enterprises should have an ability to request and review this information.

Fannie Mae, Freddie Mac, and Ginnie Mae already collect data quarterly on nonbank seller/servicers' lines of credit (committed and uncommitted) via the Mortgage Bankers' Financial Reporting Form (MBFRF). Adjustments to the current reporting would provide a more complete picture of the available capacity under committed lines. Thus, we expect the Enterprises would make any necessary reporting adjustments to align with whatever portion of committed credit lines FHFA determines to count as liquidity.

In conclusion, for the reasons set forth in this section, HPC strongly recommends that FHFA reconsider last year's decision to disallow committed lines of credit from counting toward a rigorous liquidity standard for nonbank seller/servicers. Securing such lines are standard commercial practice for obtaining backstop liquidity that enhances the economic efficiency of liquidity risk management and promotes market discipline. Further, as noted earlier, a prudent nonbank servicer will maintain a healthy liquidity buffer *above* that level to ensure ongoing compliance and such buffer will surely be made up of a mix of liquidity sources.

B. The Origination Liquidity Requirement Should Recognize Netting Agreements

The re-proposal establishes an incremental liquidity requirement for nonbank mortgage originators that use the TBA market to hedge interest rate risk. As proposed, a nonbank seller/servicer would be required to meet a two percent incremental liquidity requirement associated with its outstanding TBA hedging position. FHFA reports that it calibrated this requirement to its observations of margin calls related to hedging in the TBA market during March-April 2020. However, it is unclear if this requirement is to be applied to the gross or net positions. Also, HPC members are concerned that the proposal could add significant short-term volatility to liquidity requirements and perhaps disincentivize TBA hedging.

One of the responses to the market volatility in March-April 2020 was the expansion of netting agreements between warehouse lenders and seller/servicers. In these agreements, the warehouse lender is in the long position based on the value of the pipeline loan, which changes daily. This position is offset by the seller/servicer's TBA position, which is valued at the trade level and changes inversely to the position of the warehouse lender. Yet, particularly for large nonbank originators, the warehouse lender and the TBA dealer may be the same firm. Thus, it is possible that these contracts contain provisions that permit the positions to be netted against each other daily by the warehouse lender, resulting in a direct mitigation of margin call exposure to the TBA position for the specified bank and broker.

Therefore, HPC recommends that the origination liquidity requirement be modified to recognize the offsetting effects of these netted positions when the contracts provide for such netting. If it would add relevant data and assurance to the Enterprises, a corporate officer could report, and certify, to the netted positions. As with the discussion of committed credit lines above, we could also envision adjustments in quarterly reporting that reflect these netted positions.

We recommend that FHFA consider more broadly how the origination liquidity requirement could be modified to be based on estimated net exposure for long and short TBA positions. For instance, it is common for a nonbank to have a short position hedging their loan origination pipeline and a long position hedging their MSRs. Assessing a significant liquidity charge on price movements on the short position without recognizing the offsetting economic change on the long position negates the core purpose of hedging as a risk mitigation technique.

Finally, as FHFA considers these and other comments it receives regarding origination liquidity, the fundamental differences in origination liquidity risk and servicing liquidity risk should be carefully considered. The liquidity risk in TBA hedges can appear suddenly but also will be of limited duration since the loan manufacturing process generally runs 60 days. In contrast, a sudden spike in mortgage delinquencies sets in motion a future path of liquidity needs to make servicing advances that occurs over months, not hours or days. While the demands can be substantial, the time path of making servicer advances does not require the same day-one cash in hand as meeting margin calls. And depending on the hedging techniques used, margin calls may have offsetting adjustments that make net positions the relevant metric for defining potential cash needs.

C. The Definition of Net Worth Should be Aligned with Current Practices at Ginnie Mae and the GSEs

FHFA is proposing that the definition of net worth be based upon the definitions used by the GSEs in their financial eligibility standards. This definition could be read to require a nonbank seller/servicer to exclude from its net worth mortgage servicing rights (MSRs), mortgages, and other assets pledged against credit lines. However, such a result is inconsistent with the actual practice of the GSEs, and Ginnie Mae, and would materially reduce the net worth of nonbank seller/servicers.

As an example, based upon discussions with Ginnie Mae staff, we understand that Ginnie Mae has interpreted its definition of net worth to exclude MSRs from net worth only if the MSRs are used to secure an obligation of another entity. In other words, if a nonbank seller/ servicer uses its MSRs to secure a line of credit, that line of credit is an obligation of the nonbank seller/servicer, not another entity, and the MSRs may count toward the nonbank's net worth. Similarly, HPC members have told us that the GSEs routinely use their discretion to permit MSR and other pledged assets to count toward net worth, taking into account the terms of the pledge. Therefore, to avoid potential confusion over the treatment of pledged assets in calculating net worth, we recommend that the final standards explicitly adopt an approach toward pledged assets that is fully aligned with the practices employed by Ginnie Mae and the GSEs.

Aligning the written requirements with actual GSE and Ginnie Mae practice would promote consistency between FHFA and Ginnie Mae, and importantly, with state regulators who may be looking to the FHFA proposal as a template for their own requirements. We believe the actual practice reflects prudent business judgment and better reflects economic realities.

Attachment B provides greater detail on these points, including specific examples and explanations.

III. Features of the Re-Proposal that Require Clarification

A. Liquidity Buffers

FHFA proposes that large nonbank seller/servicers maintain a liquidity buffer that is in addition to the base requirements that all such nonbanks face. FHFA notes that the seller/servicer "could draw on [the buffer] in times of financial or economic strength" subject to Enterprise approval.

Large nonbank seller/servicers need to understand the procedures for accessing the liquidity buffer *before* a crisis, not during one. As proposed, the ability to draw on the liquidity buffer would require Enterprise approval, with FHFA providing oversight as Conservator, for individual events, and would require instructions from FHFA to the Enterprises to allow drawdowns during systemic events. In either case, large nonbanks must then submit remediation plans that adequately document how they will return to full compliance.

As we have noted above, seller/servicers will build buffers upon the buffers to avoid violating a requirement. However, without timely approval to use the liquidity buffer during a systemic disruption, the buffer will be viewed as an additional barrier to market liquidity rather than a remedy during times of stress.

HPC recommends FHFA clarify that large nonbanks subject to the requirement of establishing capital and liquidity plans should use those documents to identify potential circumstances that could involve the use of the buffers and propose metrics for re-capitalizing to the FHFA minimum once a liquidity event has ended. Given the variation in business models across nonbanks, the liquidity and capital plans will offer the opportunity for each company to outline a tailored set of liquidity procedures consistent with Enterprise requirements; as such, these plans will permit FHFA, the Enterprises, and the firm to understand and agree, ahead of a crisis, how the buffers will be accessed.

To the extent practicable, perhaps by using examples from the past, FHFA should clarify what circumstances constitute a systemic event and provide the Enterprises with the ability to respond immediately should one occur. For instance, a market disruption that causes the Federal Reserve Board to establish emergency Section 13(3) facilities could automatically trigger approval for dipping below the liquidity buffer. Dramatic changes in CRT, MBS, or MSR prices could also signal a systemic event. Regardless, the Enterprises will have real-time information as to how an unexpected liquidity event affects their counterparties. Providing such clear guidance to the Enterprises will enable them to act quickly to allow drawdowns and not wait for instructions from FHFA, promoting greater market stability in a moment of disruption.

Beyond the large nonbank buffers, HPC is also concerned with the ability for nonbanks to draw on the proposed origination liquidity requirement during TBA price spikes. FHFA describes the 2 percent incremental liquidity requirement applied to TBA hedging position as being calibrated based upon an extreme market event: the movement in MBS prices in March 2020. As such, any repeat of that sort of scenario should result in nonbank originators being able to draw down on that incremental liquidity requirement in response to margin calls, which is the purpose of building the requirement in the first place. Requiring firms to build liquidity at that moment would be procyclical and add to, not reduce, market volatility.

Separate from the appropriate use of the liquidity buffers, HPC proposes for FHFA's consideration whether a large nonbank seller/servicer could opt to meet and maintain a substantially higher net worth requirement in lieu of maintaining the proposed liquidity buffer. For example, a nonbank that had twice or more the required nine percent net worth, could use that added capital protection as an alternative to maintaining the liquidity buffer (such an entity would still need to satisfy the base liquidity requirements). The rationale here is that the significant net worth both de-levers the firm and provides it with a strong basis for raising additional funds, if needed. The firm would then avoid using equity to carry significant amounts of low-yielding assets.

B. Stress Tests

The re-proposal would require large nonbanks to carry out annual liquidity stress tests. HPC asks that FHFA provide more detail on the use and protection of stress test reporting. How does FHFA anticipate that the proposed stress tests will interact with the capital and liquidity requirements? How will FHFA and the Enterprises ensure the confidentiality of stress test results? Considering that Ginnie Mae has a program of stress testing its large issuers, does FHFA plan to coordinate with Ginnie Mae, or state bank supervisors, on any stress test requirements or reporting?

C. Third-Party Assessments

The re-proposal requires that large nonbank seller/servicers annually obtain and provide to the Enterprises an assessment of the seller/servicer's performance and creditworthiness that is prepared by a qualified, independent, third party. This assessment must substantiate that the seller/servicer has adequate capacity to perform its financial obligations in an adverse stress environment. FHFA will need to carefully consider how it plans to implement this requirement given the variety of business models subject to the requirement (for example, loan channel, relative mix of origination and servicing, and so on). FHFA will also need to consider which third parties are qualified to render such judgments.

Today, there are covered firms that do not issue debt, and firms that own servicing rights, but do not service loans. For servicers who contract with sub-servicers for servicing operations, it is unclear what a servicing rating would entail. These and other situations will need to be addressed before implementing this requirement.

HPC's members work extensively with the Enterprise teams that perform counterparty oversight. This work is comprehensive, covering the operational capability, financial strength, and business performance of each company. The independent third parties, such as rating agencies, which may perform some form of review are unlikely to engage in the type of extensive evaluation the GSEs conduct.

HPC recommends that FHFA provide information on how the independent review will be used by FHFA or the Enterprises, and which firms may qualify as independent third parties capable of performing these reviews.

D. The Effective Date

The re-proposal establishes an effective date of December 31, 2022, for the Servicer Eligibility requirements, except for the Liquidity and Capital Plans, which are due by December 31, 2023. HPC recommends the effective date for all the new requirements be the latter date. As noted above, many aspects of how seller / servicers will access liquidity during a stress event will be described in the plans submitted to the Enterprises. It is important that all parties understand expectations under the requirements and therefore align the plans with the new liquidity and capital mandates to prevent uncertainty and disruption to the market.

IV. Conclusion

Nonbank mortgage seller/servicers perform a vital role in the housing finance system, and they consist of many different structures and are varied in size and scope. Systemic stresses affect all seller/servicers, but propagate in unique ways across individual seller/servicers. While this variety is valued, for the integrity of the system, HPC recognizes that it is important that seller/servicers operate in a safe and sound manner to ensure the viability of the U.S. residential housing market. Our comments are intended to help FHFA refine the re-proposal so it can achieve that goal, while recognizing commercial best practices and other relevant considerations.

We welcome the opportunity to engage further with FHFA on any of the matters addressed in this letter.

Yours truly,

Edward J. DeMarco

Edward J. DeMarco
President
Housing Policy Council

Attachments

Attachment A

Treatment of Operating Subsidiaries of Banks

In the re-proposal, FHFA acknowledges that the Enterprises largely rely on banking regulators' prudential capital and liquidity standards as financial requirements for depository counterparties. HPC requests that FHFA clarify that this reliance extends to operating subsidiaries of banks.

It is well-settled that while an operating subsidiary of a bank is a separate legal entity, it is functionally part of a bank. An operating subsidiary of a bank may only engage in activities that are permissible for the parent bank; The bank must have the ability to control the management and operations of the subsidiary; The assets and liability of the operating subsidiary are consolidated with the bank under GAAP; The subsidiary is subject to examination and supervision by the chartering authority for the bank.

Moreover, the parent holding company for a bank must, as a matter of federal law, serve as a source of strength for the bank. This requires the parent holding company to have sufficient capital and liquidity to support the bank. The regulator of the holding company may enforce this requirement through capital directives, cease and desist orders, and civil money penalties.

In sum, the regulatory and supervisory framework applicable to an operating subsidiary of a bank that is part of a holding company structure meets the fundamental purpose of the eligibility requirements. That framework ensures that operating subsidiaries have the resources to fulfill their obligations to the Enterprises and do not pose undue counterparty risks. Therefore, we recommend that operating subsidiaries of banks that are part of a holding company structure be treated as a bank for purposes of the eligibility requirements.

Attachment B

Exclusion of Certain Assets from Capital-to-Asset Calculations

The Impact of GAAP Accounting on Nonbank Seller/Servicer Assets

Generally Accepted Accounting Principles (GAAP) rules around "failed sales" inflate balance sheet assets for certain common mortgage transactions by treating certain sold assets as financings. Two specific types of transactions are common enough in mortgages that they should be addressed explicitly in the capital requirements, though others with similar treatment are referenced below. In all cases, GAAP requires that certain assets be carried on the books of a mortgage servicer along with an offsetting matched liability, while the economic exposure to the asset that is no different than in a true sale, which these transactions meet as a legal matter.

In at least one case, Ginnie Mae guidelines and common practice by the GSEs already provide that reverse issuers may exclude from total assets Home Equity Conversion Mortgage (HECM) loans that are sold into Ginnie Mae securitization trusts (HMBS trusts). These HECMs fail GAAP sale accounting, forcing a HECM issuer to bring the entire HMBS trust onto the balance sheet. Any meaningfully-sized HECM issuer would fail the capital requirements, if not for this waiver.

A second type of transaction of this sort involves the sale of MSRs where the seller retains a subservicing agreement of more than one-year. Such transactions are also treated by GAAP as financings, requiring that the sold MSR be brought onto the balance sheet with an offsetting liability. The risks in such a transaction are probably lower for the seller than had they accepted a shorter subservicing agreement. Nevertheless, because of the vagaries of GAAP accounting, additional capital would be required in the one case versus the other. Similarly, long-term subservicing arrangements that did not involve the sale of an MSR, while not different in economic substance, do not trigger a GAAP failed sale and thus do not require additional capital. We recommend excluding such MSRs that have a matched liability from total assets to align economic reality to the capital requirements.

We recommend aligning the requirements with these actual GSE and Ginnie Mae practice. We believe the actual practice for these transactions reflects prudent business judgment and better reflects economic realities. As a result, we believe these transactions should be excluded from the calculation of the minimum capital-to-asset ratio.

Sale Accounting Treatment

The transactions below do not achieve GAAP sale accounting treatment despite being true legal sales:

a. <u>HECM loans sold into GNMA securitization trusts (HMBS pools), with the servicing rights being retained by the issuer</u>

In HECM securitization transactions, the issuer/servicer has certain requirements related to the securitization trust. These include a requirement to repurchase loans from HMBS pools once their UPB reaches 98 percent of the Maximum Claim Amount for the loan. These loans are then transferred to HUD, typically within a few weeks. Another requirement is that the issuer/servicer be paid by issuing so-called "tail draws," issuing GNMA-back HECM securities, when the borrowers on an HECM loan are not making any cash payments from which to pay the servicing spread and fees, as HECM borrowers do not make pay cash payments from which to pay the servicing costs.

Due to these requirements, the transfer of HECM loans does not qualify for sale accounting treatment and is accounted for as part of "loans held for investment," with an offsetting matched liability. Under GAAP accounting, the entire securitization is recorded on the issuer/servicer's balance sheet. Yet, once the HECMs are sold to GNMA trusts, they become assets of the trusts and the issuer/servicer does not have any claims on those loans. Similarly, holders of the HMBS have no recourse against the assets of the issuer/servicer.

b. <u>RMBS trusts</u>

Like HECM securities, an issuer/servicer that holds a residual interest in an residential mortgage--backed security (RMBS) security may be required to bring the entire security onto the balance sheet. This is a particular issue for non-QM issuers. We believe only the residual interests should be counted as an asset and not the entire transaction for net worth purposes. This is because holders of the securities issued by these trusts have recourse only against the assets of the RMBS trusts and have no expanded claims on the assets of the issuer/servicer.

c. <u>Rights to MSRs and long-term sub-servicing contracts</u>

Because of sale accounting requirements, GAAP often requires, for long-term sub-servicing contracts, that the entire MSR asset be placed on a servicer's books when advancing and all other responsibilities of ownership have been purchased by and transferred to a 3rd party. The length of the sub-servicing contract and ease of termination are among the key determining factors in its accounting treatment. We recommend excluding MSR assets that have an offsetting liability where the ownership of the MSR was transferred to another party while subservicing was retained. Without the flexibility to exclude these assets from net worth, servicers would have an incentive to enter shorter and more easily terminated agreements, which is contrary to prudential management and market stability.