April 18, 2022

CHLA Comments: FHFA Proposal to Enhance Enterprise Seller/Servicer Requirements

Ms. Sandra L. Thompson
Acting Director, Federal Housing Finance Agency
400 7th Street, S.W.
Washington, DC. 20219

Dear Acting Director Thompson:

The Community Home Lenders Association (CHLA)[1] is pleased to submit comments regarding FHFA's proposed increases in Enterprise seller/servicers' requirements, released on February 24.

CHLA's March 2020 comment letter on the prior FHFA proposal recommended different financial requirements for small and large seller/servicers, since Enterprise counterparty risk and advance exposure, as well as servicer systemic risk, are overwhelmingly concentrated in the very largest servicers.

Therefore, CHLA appreciates that FHFA has taken a major step in this direction through establishment of Capital and Liquidity Plan requirements and annual risk assessments for only large IMB seller/servicers. This makes much more sense than only ratcheting up requirements for all seller/servicers, big and small alike, such as the 2020 non-performing loan liquidity proposal, which we appreciate has been dropped.

CHLA also appreciates that servicing Liquidity Ratios now more accurately reflect the lower advance responsibilities associated with actual servicing compared to the scheduled servicing option.

However, as explained herein, CHLA believes that increased bank-like capital standards are not needed to address Enterprise counterparty risk and advance exposure and could harm access to mortgage credit.

Therefore, CHLA offers the following comments and recommendations regarding this proposal:

- **The 2% liquidity requirement for TBA hedging of new loans should be eliminated for smaller seller/servicers, as it is bad for consumers, unnecessary, and counterproductive.**
- **Net Worth and Capital Ratios are not now a problem - but are a barrier to entry, and along with the hedging requirement, will lead smaller IMBs to stop selling to the Enterprises.**
- **The FHLB should establish an advance program for bank warehouse lenders to fund IMB servicer advances, to enhance liquidity for IMBs' role as banker to defaulted borrowers.**
- **FHFA should restore the flexibility that was taken away in December 2020 to count unused portions of committed lines of credit toward Liquidity Ratios, with haircuts as appropriate.**
- **Liquidity ratios should more accurately reflect servicer advance exposure: (1) reduce actual servicing from 3.5 to 1.5 BPs, & (2) base non-agency ratios on whether actual or scheduled.**
- **The effective date of increased requirements should be delayed until January 1, 2024.**

[1] CHLA is the only national trade association that exclusively represents independent mortgage banks (IMBs). CHLA members are small and mid-sized community-based IMBs, whose sole business is originating and servicing residential single-family mortgage loans.

General Discussion

The definitional changes to Net Worth requirements are reasonable. However, increasing the Capital Ratio from 6% to 9%, while not seemingly a problem now for most seller/servicers, goes well beyond what is necessary to address Enterprise counterparty risk, at least for smaller seller/servicers.

Enterprise counterparty loan loss exposure to seller/servicers is very limited. Enterprise counterparty loan loss risk from loan purchases from a seller/servicer is basically limited to that seller's failure to meet loan repurchase obligations the Enterprise may impose for improperly underwritten loans. This is an indirect and significantly smaller counterparty risk, for example, than is posed by Private Mortgage Insurers, which (unlike seller/servicers) directly absorb 100% of losses (on the high LTV portion of a loan).

Of much greater concern is the 2% hedging requirement, which seems to be based on an objective of ensuring servicers always make advances on time, so Fannie and Freddie do not ever have to do so (even though they already do so on actual serviced loans). Unfortunately, this requirement will have significant negative real-world consequences to consumers - due to increased concentration and less competition.

We appreciate that Fannie and Freddie have a legitimate interest in the continuity of their seller/servicers - that they will continue to be a going concern. However, as CHLA has previously noted, the failure of smaller non-bank seller/servicers has a very limited impact in the real world. On the origination side, they are no longer available to originate loans – and as noted, may not be able to execute on Enterprise repurchase requests. On the servicing side, the historical record is clear that it is relatively easy to transfer servicing – generally without loss – from a small servicer to a large servicer.

Thus, the requirements go well beyond what is needed to address Enterprise counterparty risk and advance exposure, imposing bank-like capital requirements more characteristic of a financial regulator.

We would point out that non-bank seller/servicers are already subject to extensive financial scrutiny from their warehouse lenders, which have direct and much more immediate financial exposure to such firms. In practice, warehouse lenders are likely to force corrective financial action on an IMB long before an Enterprise is actually impacted by financial difficulties of an IMB.

Unfortunately, imposing unnecessary liquidity requirements could come at a significant price: the erosion of one of the Enterprises' greatest strengths, the breadth of its seller/servicers. Many solvent smaller IMBs, facing big liquidity increases, will elect to simply sell their loans to aggregators instead of to the Enterprises. And, some privately held smaller IMBs may elect to sell their firm to a large IMB. Fewer seller/servicers translate into fewer consumer choices, less competition, and less personalized service.

Ironically, imposing excessive liquidity requirements on smaller seller/servicers could also **increase** Enterprise risk in one important way. There will be more concentration in a few large seller/servicers, where the great majority of Enterprise financial risk - and virtually all the systemic risk - reside.

In our 2020 comment letter on the prior FHFA proposal for seller/servicer requirements, CHLA extensively documented the significant risk differential between large and small seller/servicers and argued for different financial requirements that reflect this risk differential. As noted, CHLA very much appreciates that the current proposal takes a significant step in that direction – creating some requirements that only apply to large servicers (in lieu of across the board requirements like a new NPL liquidity factor) and creating different liquidity ratios for actual and scheduled servicing.

To further protect smaller IMBs, CHLA is now asking FHFA to build on this approach, by:

- Exempting smaller servicers from the 2% TBA hedging liquidity requirement.
- Creating an FHLB advance program for bank warehouse lenders to fund IMB servicing advances.
- Reducing the liquidity ratio even further for actual servicing, down to 1.5%.

These recommendations are explained in detail in the narrative that follows.

2 % Liquidity Requirement for TBA Hedging

CHLA's topline recommendation is that FHFA withdraw, or at least exempt smaller seller/servicers from, the 2% liquidity requirement on TBA hedged loans. This requirement creates a significant new liquidity burden on smaller seller/servicers – which comes on top of the increased servicing liquidity ratios if they service loans – and is in addition to the proposed 50% Capital Ratio increase from 6% to 9%.

Following are reasons why a 2% hedging requirement should not apply to smaller seller/servicers:
1. The 2% TBA hedging liquidity requirement is entirely inappropriate for the smaller IMBs that don't service loans, service *de minimis* levels of Enterprise loans, or use the actual servicing option. The 2% requirement would apply equally to both large mega-servicers that dominate Enterprise servicing and smaller lenders that sell loans servicing released or have very limited advance responsibilities because they service *de minimis* levels of loans or solely or primarily do actual servicing. There is zero or very limited advance exposure there, so this 2% requirement is clearly not appropriate for such smaller IMBs.

2. The 2% TBA hedging liquidity requirement is a significant burden on smaller seller/servicers. Consider a small IMB lender, with a monthly origination volume of $62.5 million, that does not do servicing. A 2% hedging requirement, with a two-month pipeline, translates into a required liquidity of $2.5 million. This is a significant burden, on top of the required boost in the Capital Ratio from 6% to 9%. Notably, this same firm, if they just met the minimum Net Worth of $2.5 million, would have to have 100% of their Net Worth in cash/liquid assets just to meet the 2% hedging ratio.

3. The 2%TBA hedging Liquidity requirement would hurt consumers by increasing concentration. One of the Enterprises' greatest strengths is its breadth of seller/servicers. The 2% hedging requirement would undermine this, by increasing concentration in Enterprise loans. Faced with much higher liquidity requirements, many solvent smaller seller/servicers will decide to sell to aggregators instead of directly to the Enterprises. This could impair cash window pricing, since it is the capability of small and mid-sized IMBs to securitize loans that maintains the incentive for the Enterprises to keep cash window pricing fully competitive with securitization pricing. Moreover, dislocations caused by the PSPA restrictions in 2020 showed that small Enterprise securitizers offer consumers better pricing in a crisis than aggregators do.

4. The 2% TBA hedging Liquidity requirement would increase risk by increasing concentration. The resulting increased concentration cited in item 3 just above would increase Enterprise financial counterparty risk and servicer systemic risk, as the riskiest mega-servicers garner more of the market.

5. The 2% TBA hedging liquidity requirement would increase risk by dis-incentivizing hedging. Hedging in the TBA market is done to reduce risk. Imposing this significant new liquidity requirement on hedging is likely to discourage hedging. In turn, the impact of a reduction in the use of hedging could be an increase - not a decrease – in counterparty risk that a seller/servicer might pose to the Enterprises.

6. The 2% TBA hedging Liquidity requirement significantly overstates the risk that hedging poses. Presumably, this requirement is in response to the March 2020 Federal Reserve precipitous reduction in interest rates, which led to some margin calls on IMBs. CHLA is not aware of any IMBs that went out of business due to such margin calls, even though it was a period of rapidly escalating advance requirements and a forbearance mandate. Moreover, this is a classic mark to market distortion; the hedge reflects a loss that is fully or partially offset by assets (loan commitments) that increase in value when the loan closes.

For all these reasons, FHFA should eliminate the 2% TBA hedging requirement for smaller servicers - using the proposal's $50 billion servicing threshold or some other appropriate cutoff.

Alternatively, **if** FHFA elects to retain this 2% hedging liquidity provision for smaller seller/servicers, it is critically important that this requirement is implemented in a way that makes it a true reserve to be drawn down on in times of crisis - and not merely a continual ratcheting up of liquidity requirements. If there is a crisis that forces a drawdown of reserves that were used to meet this 2% requirement, smaller IMBs should not be required to quickly replenish the reserve, but should be allowed to draw down on it to ride a crisis out, meeting the ratio over time. This is consistent with the principle that the purpose of buffers like this is to enable a firm to survive a crisis – and not to accelerate the crisis for market participants.

Other Provisions Not a Problem Today, But are Barriers to Entry, Discourage Sales to Enterprises

Definitional changes to the Net Worth requirement and the 50% increase in the Capital Ratio do not appear to pose a challenge to CHLA members **at this time**, and our impression is that they are not a big problem for most seller/servicers.

However, CHLA does not consider our organization as only representing our actual members. We also consider the impact on non-member smaller IMBs - including future entrants into the industry. We take this position even though in the short run, raising financial requirements might even modestly benefit CHLA Members, by reducing the threat of competition from new startups.

As noted, counterparty and advance risk posed by IMBs is already extremely limited. Therefore, we do not believe the increased Capital Ratio from 6% to 9% is actually needed to address counterparty risk, and this is even more true of the 2% hedging liquidity requirement, at least for smaller IMBs.

A major source of capital and liquidity for smaller IMBs is the accumulation of profits from ongoing origination and servicing. Therefore, raising financial requirements could be a particular impediment to smaller potential IMB startups which don't have access to capital markets.

Moreover, if margins shrink at IMBs, as some predict, existing seller/servicers that now comfortably meet FHFA requirements may have more difficulty in doing so in a few years, even though their solvency is not in question. As noted, the likely result is that many solvent IMBs will simply elect to stop selling loans to the Enterprises, and revert to acting as correspondents, selling loans to investor/aggregators.

This would not reduce the risk of such firms going out of business, since they would still be originating these same loans. Instead, these IMBs would simply be selling the loans to aggregator/investors, which would in turn sell the loans to Fannie and Freddie, thus increasing concentration in Enterprise loans.

Another phenomenon that will be encouraged by the increase in the Capital and Liquidity Ratios is a trend we see where owners of privately held IMBs decide for various reasons (including regulatory creep) to sell their firm to a larger IMB. This also increases concentration and reduces consumer choices.

An FHLB advance program for bank warehouse lenders to fund IMB servicer advances

Instead of only focusing narrowly on increased liquidity requirements for IMBs, CHLA urges FHFA to also focus on ways to enhance liquidity of, and confidence in, IMB seller/servicers.

Therefore, CHLA proposes that FHFA, as regulator of the FHLBs, take the necessary steps to enable the FHLBs to establish an advance program for IMB seller/servicers. As the FHLBs already make advances to banks, this could be structured by making an advance to a bank in its capacity as a warehouse lender to an IMB Enterprise seller/servicer. The principal purpose of such a program would be to enhance the liquidity of IMBs to make advances – including in market conditions where advance obligations increase.

Both banks and nonbanks (IMBs) that service Enterprise loans are required to effectively act as a banker to defaulting borrowers. When a borrower fails to make a mortgage payment, the servicer must advance certain payments not made by borrowers.

This advance (loan) does not represent any real financial risk, since the payments are ultimately backstopped by the underlying Enterprise guarantee on the loan and are usually recovered when the borrower resumes payments on the loan or undergoes loss mitigation, or the loan is foreclosed.

Banks enjoy confidence that they will continue as going concerns, including making such advances, due to a number of federal guarantees or credit facilities, including: (1) taxpayer-backed FDIC insurance on bank deposits, (2) GSE-type FHLB advances, backed by mortgage loans, and (3) access to the Federal Reserve discount window. We also learned from TARP that in financial crisis, banks will be bailed out.

In contrast, IMBs do not have access to any of these guarantee or liquidity sources. This is generally not a problem for IMBs, since their main line of business is the origination and servicing of federal agency loans, that are in turn guaranteed by either Ginnie Mae (FHA/VA/RHS), Fannie Mae, or Freddie Mac. The only real question is IMB servicers' ability to fulfill their banking function of making advances.

The FHLB already makes advances to banks. This new liquidity facility that we are proposing would expand the FHLB's mission of access to mortgage credit, by adapting it to the objective of more IMB liquidity and enhanced confidence in timely advances of borrowers' missed Enterprise loan payments.

Moreover, the mere existence of such a program – even when not used – would increase confidence that IMBs would make timely required advances.

How do we know this? In 2020, as COVID loan defaults accelerated and concerns heightened that servicers might have trouble meeting Ginnie Mae (and to a lesser extent Enterprise) advance requirements, Ginnie Mae established a standby credit facility, called the PTAP.

In practice, the predicted surge of Ginnie Mae issuers unable to meet advance requirements did not materialize. This was due to many factors, including effective implementation by the FHA and Enterprises of partial claims for distressed borrowers and the underlying financial resilience of IMBs.

However, we also believe the existence of the PTAP program played a positive and constructive role. Even though very few Ginnie Mae issuers used the program, it engendered confidence among IMB warehouse lenders that a liquidity facility was available to meet advance needs in a crisis.

Additionally, we also ask FHFA to work on developing a broader FHLB advance program for Enterprise seller/servicers, which would also include IMBs that do not do servicing.

Flexibility Should be Restored to Use Unused Portions of Committed Lines of Credit for Liquidity

In December 2020, FHFA ended flexibility to count the unused portion of committed servicing advance lines of credit from assets eligible to meet liquidity requirements. CHLA requests that FHFA restore such flexibility, with appropriate haircuts to reflect the fact that such lines are not as liquid as cash.

FHFA's December 2020 action created counterproductive incentives. Because unused lines no longer count for liquidity, this reduces the incentive to secure, hold, and pay for such lines, even though they enhance liquidity. It also creates an incentive to artificially draw down such lines at the end of a quarter.

Unquestionably, such unused portion of committed servicing lines have **some** value in terms of liquidity. We urge FHFA to restore the authority to count such lines – with an appropriate haircut. This could be in the form of some percentage of the unused line of credit, a cap on the percentage of the liquidity requirement that could be met through use of such lines, or some combination or variation thereof.

Align Liquidity Ratios Better with Advance Responsibility of Different Servicing Options

As noted, CHLA appreciates that FHFA established a lower 3.5 basis point liquidity ratio for loans serviced under an actual servicing option for Enterprise loans. However, given the very low advance requirement levels under actual servicing, we would further recommend reducing this to 1.5 basis points.

On the other end of the spectrum is non-agency loans. We see no reason to establish an arbitrarily low liquidity ratio of 3.5% for all such loans. For portfolio loans, we recommend a Liquidity ratio of 10 Basis points, the same as is established for Ginnie Mae loans, since liquidity exposure is comparable.

For Private Label Securities (PLS) loans, we would suggest that the ratios track the requirements for Enterprise loans. That is, if the terms of the PLS servicing agreement are scheduled/actual, the Liquidity Ratio should be the scheduled/actual ratio - and if the servicing agreement are actual/actual, the Liquidity Ratio should be the Actual/actual ratio for Enterprise loans.

Delay in Effective Date

Implementation of significant liquidity ratio increases and a 50% Capital Ratio may make year-end compliance challenging for some firms, particularly for smaller, closely held IMBs that grow their net worth and liquidity organically.

Therefore, we request that the effective date of the increases be moved back one year to January 1, 2024.

If the 2% hedging requirement is dropped, a gradual increase in the Capital Ratio requirement would be fine - e.g. 7% end of this year, 8% mid-year next year, 9% beginning of 2024.

In closing, we thank you for your consideration of these comments and recommendations.

Sincerely,

COMMUNITY HOME LENDERS ASSOCIATION