STRUCTURED
FINANCE
ASSOCIATION

May 27, 2020

Mark A. Calabria
Director
Federal Housing Finance Agency
400 7th Street, SW
Washington D.C. 20219

Dear Director Calabria:

On behalf of the 370 corporate members that comprise the Structured Finance Association, a trade group representing the entire value chain of the structured finance and securitization industry, I am writing to you today to request that the Federal Housing Finance Administration ("FHFA"), as the conservator of Fannie Mae and Freddie Mac (collectively, the "GSEs"), direct the GSEs, commensurate with other GSE security arrangements and fellow regulatory guidance, to not treat a loan in forbearance under the CARES Act as a delinquent loan under its "fixed severity" CRT bonds issued in 2013 and 2014.

We initially drafted this letter before the FHFA published on May 20, 2020 its comprehensive proposed rulemaking on the regulatory capital framework for the GSEs, which is yet one more of the recent important steps taken by the FHFA to respond to and lead on the COVID-19 pandemic and ensure the future strength and vitality of the GSEs. SFA has commended the steps FHFA has taken to relieve servicers of advance obligations in GSE pools after 120 days in a CARES Act-mandated forbearance period. We think FHFA struck the right balance by allowing the GSEs to facilitate a functioning market without purchasing loans out of MBS pools, as if they were delinquent loans. We also appreciate your work to ensure the ongoing safety and soundness of our housing system. The enterprises, as you know, operate with considerable advantages in the market given the explicit and implicit government backing. Without appropriate leadership from the FHFA and Congress that addresses underlying market structural issues, that is how they will operate into the future, perhaps permanently. In the meantime, however, the steps that FHFA takes on its own have considerable consequences for how the markets will function for years to come. And as you look to raise new equity capital, decisions you make today will have a direct consequence on those costs.

While we will be filing a comment letter on your proposed capital rule, finalizing these proposed regulations after notice and comment rulemaking will take several months. But in the interim, we believe that the FHFA will need to grapple with the issue raised in this letter before the ultimate effective date of final capital regulations. Accordingly, we have elected to submit this letter for consideration in the context of these earlier fixed severity CRT bonds.

As we detail below, in enacting the CARES Act, Congress mandated the provision of forbearance to borrowers experiencing financial hardship caused directly or indirectly by COVID-19, without regard to whether such hardship actually impaired a borrower's ability to make regularly scheduled monthly mortgage payments. Put another way, by statute, Congress effectively amended the original loan terms to reschedule the due dates of otherwise regularly scheduled monthly payments and made clear that such rescheduled loans must be reported as current to credit reporting agencies.

Ultimately, it is clear that the forbearance mandated by the CARES Act is more like a deferral, despite the statutory label, and not a traditional forbearance of the type contemplated in the CRT bond transactional documents. We believe that these transactional documents should be interpreted in a manner that is consistent with the intent of the CARES Act and the unique context in which a perhaps misnamed forbearance is granted as a result of the COVID-19 pandemic.

BACKGROUND

As you know, in 2013 and through 2014, the GSEs issued the CRT bonds through a structure known as "fixed severity," whereby any borrower who went more than 180 days delinquent would be counted as a default. The classification of a loan as delinquent has a material consequence on the GSEs' obligation to repay the bonds. The transaction documents require that the unpaid principal balance of a delinquent loan be multiplied by a fixed severity factor to calculate a simulated loss that could be expected to occur based on past historical data. Subject to a variety of other elements, this simulated loss is borne by bond holders and results in a reduction of the amounts payable by the GSEs. Thus, if forbearances in the "Referenced Pools" pertaining to CRT bonds are considered to be delinquencies, investors would receive payments by the GSEs under the bonds in lesser amounts than if the loans subject to forbearance were classified as current or performing.

In subsequent CRT bond deals, the GSEs added detail to make clear that forbearances are treated differently depending on the circumstance in which the forbearance arose. Fannie Mae added Casualty Event language and Freddie Mac added Natural Disaster language in later fixed severity deals, the result of which was to not treat forbearance or deferrals granted in that context as delinquent.

WHAT IS FORBEARANCE FOR CRT?

Generally speaking, a loan due on the first of the month is considered delinquent when all or part of one or more payments remains unpaid as of close of business on the last day of the month. For a payment to remain unpaid, however, it must be due and payable in the first place, which raises the question of what is a forbearance as required by the CARES Act. A CARES Act forbearance is not like a typical forbearance. Based on the historical precedent for what counts as "forbearance," a CARES Act "forbearance" is much more akin to a deferral.

In its most traditional sense, a forbearance occurs when a holder elects not to impose contractually available remedies in respect of a delinquency or default by the borrower. Or, as the Oxford Dictionary defines it, forbearance is "the action of restraining from exercising a legal right, especially enforcing the payment of a debt." But in this case, there is not yet any legal right that the servicer may exercise and as to which the servicer is exercising restraint. The borrower is not in default, and the borrower does not have to prove that a default is imminent. Instead, the servicer affords the borrower his or her newly enacted statutory right to <u>reschedule</u> the terms of the mortgage loan by deferring the dates on which regularly scheduled payments are due.

A loan payment cannot be past due if by federal law it both is not required to be paid and is rescheduled. Moreover, the CARES Act requires a servicer to treat loans subject to forbearance under the CARES Act as current for purposes of reporting to credit reporting agencies.

The manner in which a borrower may obtain a forbearance under the CARES Act further demonstrates that the loan subject to forbearance should be treated as current for all contractual purposes. Borrowers who believe that they are experiencing financial hardship due to COVID-19 have a statutory right to defer payment; as long as the borrower attests to financial hardship directly or indirectly due to COVID-19, the servicer may not reject the borrower's request. The borrower does not have to prove either the existence of the financial hardship or such financial hardship's adverse impact on the borrower's ability to make regularly scheduled monthly payments. And finally, the servicer is prohibited from requiring the borrower to submit documentation supporting the borrower's attestation. These are not in any way typical forbearance practices.

Further, as you likely know, and in fact as you highlighted in a recent speech to the Mortgage Bankers Association, many of the largest mortgage servicers have reported that a significant number of their borrowers in CARES Act/COVID-19 "forbearance" plans continue to make regularly scheduled monthly payments. When asked why by the servicers, the typical answer is that the borrower looks at the payment deferral option as a type of insurance, that they want to have available if and when they need it and do not want to risk the unavailability of such an option if the eligibility criteria subsequently change. Clearly, then, there very well may be a substantial gap between the reported numbers and the realized losses in the loans of these underlying securities, which is what CRT is meant to protect against.

We do not yet know whether these loans will go into default, or whether these borrowers will remain current. CRT is designed to absorb losses from the former, and investors in these securities are prepared to take losses if or when that occurs. But treating a COVID-19 "forborne" loan as delinquent is inconsistent with the reality of the situation as well as the underlying purpose of the simulated loss concept that is fundamental to the fixed severity CRT deals, because such treatment is not a reliable proxy of anticipated losses based on past historical data.

Normally a borrower does not have a federal statutory right to this type of option, or to forbearance at all. Nor is such an option automatic based solely on a borrower's request. Rather, it is based on the GSEs' eligibility requirements based on their loss mitigation waterfalls that are available for a borrower who actually is in default or is in imminent default. Typically, servicers are required to obtain supporting documentation from the borrower to evidence his or her imminent default, if the borrower is not already in default, and the servicer must evaluate the supporting documentation in relation to the established eligibility criteria; if the borrower is not eligible, the servicer may not grant the requested relief. These are but a few examples of the ways in which the terms offered under CARES Act diverge from the practices of forbearance as understood and contemplated in fixed severity CRT transaction documents.

We believe that these fundamental distinctions between a traditional forbearance and a COVID-19 "forbearance" is the reason why, on April 7, the federal banking regulators released an interagency statement saying that if a loan was current when the deferral was granted, the deferral would be treated as a change in the contractual payment obligation. As a result, the loan would never become past due and the regulatory capital treatment of the loan would not change. See center of page 4: https://www.occ.gov/news-issuances/news-releases/2020/nr-ia-2020-50a.pdf. Under Basel III, a bank is required to assign a punitive risk-weight to a loan 90 days or more past due. 12 C.F.R. § 217.32(k). This negative treatment is why the regulators structured their April 7th guidance to avoid the forborne loan being treated as delinquent. The fact that the banking regulators referred to a COVID-19 forbearance as a deferral, and not a delinquency, is instructive for CRT bonds as well.

FHFA'S TREATMENT OF FORBEARANCE FOR REGULATORY CAPITAL PURPOSES

Also relevant to treatment of forbearance in the early fixed severity CRT bonds is how FHFA treats forbearance for regulatory capital purposes. While FHFA's temporary capital requirements put in place in 2017 are not public, we understand that its' 2018 proposed permanent capital requirements are based on the 2017 framework and will remain in effect until the newly proposed capital framework is finalized. Like federal banking regulations and Basel III, the 2018 capital requirements in part rely on the classification of loans both held in portfolio and backing MBS guarantees; they refer to this classification process as assigning loans to one of five segments: a new origination loan, a performing seasoned loan, a non-modified re-performing loan, a modified re-performing loan, and a non-performing loan.

Forbearance pursuant to the CARES Act does not neatly fit into the five enumerated segments. Is a forborne loan that was current at the time of forbearance a non-performing loan, a performing loan or a modified re-performing loan? The 2018 proposed capital framework does not say, but the newly proposed capital framework is cognizant of the conundrum and asks for comment as follows:

Question 37: Should a delinquency associated with a COVID-19-related forbearance cause a single-family mortgage exposure to become an NPL?

Question 38: Which, if any, types of forbearances, payment plans, or modifications should be excluded from those that cause a single-family mortgage exposure to become a modified RPL? Should a forbearance, payment plan, or modification arising out of a COVID-19-related forbearance request cause a single-family mortgage exposure to become a modified RPL?

From a capital requirements perspective, the "risk multiplier" values increase or decrease the credit risk capital requirements based on the loan's "assigned loan segment" and other specified risk characteristics. The risk multiplier is highest for non-performing loans with modified loans having the second highest multiplier. Thus, assigning a forbearance loan to one segment over another will have a material impact on the regulatory capital requirements of the GSEs.

But this issue also is impacted by the effect given to loans included in existing CRT deals. The GSEs enjoy capital relief from loans subject to credit risk transfer arrangements, and the relief would be highest for non-performing loans. We have not fully digested the discussion in the newly issued proposed rulemaking on the treatment of capital relief trades in the calculation of the GSEs' regulatory capital. Without SFA itself taking a position at this time, we do note that the FHFA would continue to give weight to the existence of CRT trades, but recommends in the proposed regulations that such weight be diluted.

Under the existing capital framework in place, FHFA may have a vested interest in classifying a forborne loan in a "Reference Pool" to which a CRT bond pertains as delinquent or non-performing, even if the characteristics of a forborne loan under the CARES Act are more like a performing loan. Conversely, if a loan subject to forbearance is not included in a "Reference Pool" pertaining to a CRT bond, FHFA might prefer the loan be classified as a performing seasoned loan, or secondarily as a modified re-performing loan, to lessen the risk multiplier and resulting capital requirements. Again, the FHFA has to face this issue before the proposed regulations are finalized.

REQUEST

With this background in mind, it seems clear that loans included in a Reference Pool that have asked for the forbearance option available under the CARES Act should not be considered delinquent under the corresponding CRT bond transactional documents. Moreover, we believe that interpreting such loans as delinquent would stand in contradiction to the stated intent of the program, the marketing descriptions of the program delivered to investors upon issuance, the treatment of these loans by other federal banking agencies, and the treatment of temporary forbearance by all subsequent CRT deals. We are not asking for an amendment of the related transactional documents. Rather, we believe it is reasonable and necessary to interpret the existing contract provisions to be consistent with this position.

The GSEs appear to recognize the unique characteristics of a forborne loan subject to the CARES Act by electing not to "reclassify" or render "inactive" MBS loans in CARES Act forbearance after a specified time period as they otherwise do with delinquent loans. This is of course because the CARES Act is the result of global pandemic not seen since well before both the creation of the GSEs and the gathering of historical loan performance data. It likely will be several months, if not years, until we have more reliable data on the likelihood and severity of credit loss on loans subject to a CARES Act forbearance.

Ultimately, failing to account for the unique characteristics of a COVID-19 "forbearance" could unfairly shift the risk of actual loss to investors in CRT bonds based on overly imprecise calculation of simulated loss. This result would likely dampen investor enthusiasm and thereby undermine the public policy enunciated in the GSEs own strategic plans to increase their reliance on capital relief trades. Whatever your view of CRT – and we understand your view that it is no replacement for new equity capital – it is a hedging mechanism that reduces economic risk under the ordinary course of economic cycles. Further, it is the primary vehicle for mortgage credit investors today, who will very likely be investors you would look towards to raise new loss absorbing capital in the future. Importantly as well, these early fixed severity CRT deals would continue to provide this hedging protection with the correct performing classification of loans subject to CARES Act since the investors would still absorb losses if the loan actually becomes 180 days delinquent following payments becoming legally payable. Deviation from the intent of these securities prior to knowing whether the underlying loans will actually cause, or

STRUCTURED FINANCE ASSOCIATION

are reasonably likely to cause, realized losses would not only undermine confidence in these assets, but would undermine confidence in any claims made by the GSEs when they attempt to issue new securities.

Accordingly, we respectfully request that FHFA direct the GSEs to interpret the transaction documents for these older fixed severity CRT bond deals to classify loans subject to the CARES Act forbearance option as performing loans.

We are available to discuss at your request. We very much appreciate your consideration, and, as always, we are available at any time to help you succeed in your role.

Sincerely,

Michael Bright
Chief Executive Officer