September 8, 2014

The Honorable Mel Watt
Director, Federal Housing Finance Agency
4000 7th St SW, Ninth Floor
Washington, D.C. 20024

Re: Request for Input on Guarantee Fees

Dear Director Watt:

The Center for American Progress, the Mortgage Finance Working Group, and the Consumer Federation of America submit this comment in response to your Request for Input (RFI) on the guarantee fees, or "g-fees," charged by the Enterprises.[1] We commend FHFA for reaching out to stakeholders in a comprehensive way on a topic that plays such a significant role in the ability of America's families to access affordable credit through the conventional market.

Because a discussion about pricing can quickly become quite technical and detailed, we urge you to consider the g-fee issues in the larger context of the role of affordable mortgage credit in building a stronger nation. Research and our lived experience confirm the link between housing and economic opportunity in this country, from the many benefits of homeownership for families and communities to the central role of the housing economy on economic vitality. A healthy housing market will offer opportunities for young people to begin building wealth through homeownership, for growing families to access good schools and neighborhood amenities, and for older people to choose whether to age in place or seek a smaller or more supportive environment.

Whether homeownership provides these benefits depends in large part on the way that housing is financed. That is why, since 1932, the government has sought to foster a mortgage marketplace that is stable, safe, efficient and affordable.[2] The mechanisms have evolved over time, but particularly in the wake of the recent financial crisis and Great Recession, Fannie Mae and Freddie Mac have played an outsize role in making mortgages available to America's families. Thus, this conversation about their pricing practices is both urgent and critically important.

We also urge you to consider the vastly different posture of the Enterprises in 2014 compared to 2008. When the conservatorship was initiated in 2008, housing prices were dropping, foreclosure rates were rising, and the Enterprises were in dire straits financially. Weeks after the conservatorship, the entire U.S. financial system came close to collapse, and the country entered into the deepest recession it had experienced since the Great Depression. In the years following, the Enterprises required numerous infusions of support from the U.S. Treasury to maintain solvency for a total of $188 billion

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[1] The Center for American Progress is a nonpartisan think tank dedicated to improving the lives of Americans through progressive ideas and action. CAP convenes the Mortgage Finance Working Group, a collaboration of experienced housing finance experts, affordable housing advocates, and leading academics who started meeting in 2008 to better understand the causes of the mortgage crisis and to discuss policies that will shape the future U.S. mortgage market. The Consumer Federation of America is a nonprofit association of some 300 national, state and local pro-consumer organizations created in 1968 to represent the consumer interest through research, advocacy, and education.

[2] See the Federal Home Loan Bank Act, Pub.L. 72–304, 47 Stat. 725

Today, as the conservatorship approaches its 6^{th} anniversary, the Enterprises are in a very different financial condition, having returned to profitability due to a very strong book of new loans, a decline in foreclosure rates, an increase in home prices, and numerous big-dollar settlements with financial institutions. These profits have enabled them to use deferred tax assets, further improving their financial position. During the past two years, the GSEs have returned under the net sweep provision of their stock purchase agreement well in excess of the $188 billion draw to the U.S. Treasury.[3]

At the same time, it has become clear that the conservatorship is not a short-term arrangement that will soon lead either to winding down the Enterprises or returning them to shareholders under their charters. In light of the GSE's continued central, critical role in the national mortgage market as well as their general financial health, the conservatorship has evolved into a long-term arrangement in which the U.S. Treasury will retain a significant amount of control over them through the terms of the Senior Preferred Stock Agreements that were put in place at the same time as conservatorship. Congress has so far failed to enact comprehensive GSE reform, and prospects for such reform appear dim any time prior to the 2016 presidential election. Plus, even after reform is passed, a transition period will likely last at least a decade.

Consequently, as we enter what might be called Phase Two of the conservatorship, we believe FHFA's priority should be to use the extraordinary powers of conservatorship to maintain a liquid, resilient, inclusive mortgage market that provides liquidity for the broadest possible range of credit needs. Although fortunately the worst of the foreclosure crisis is behind us, the housing market has not fully recovered, with stubbornly persisting price declines and market weakness in some areas. At the same time, certain populations, including people of color, low-income people, and Millenials, are experiencing difficulties in obtaining credit that are hampering their ability to buy, contributing to the housing market's sluggish recovery, and delaying them access to the benefits of sustainable homeownership. FHFA's choices will play a very significant role in how this future unfolds.

Before turning to your specific questions, we want to highlight the following important points:

1. The Enterprises are public purpose organizations chartered to "foster liquid, efficient, competitive, and resilient national housing finance markets (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities)." As such, pricing should be based on what is needed to cover expected losses and costs -- including a justifiable cost of capital -- and protect the taxpayer in the event of stress scenarios, rather than on pursuing particular market shares for non-GSE entities or sectors.

2. To help the Enterprises achieve their charter mission, the pricing structure should be transparent, countercyclical (or, at the very least, not pro-cyclical), and take full advantage of the Enterprises' unique ability to pool risk.

3. Expected loss pricing is trivial relative to the capital-related aspects of the proposed (and current) pricing. Capital set aside to protect against stress conditions posed by macroeconomic

[3] We do not think it is relevant to this discussion to determine whether the GSEs have "paid back" the taxpayers.

risks should be allocated evenly across the book. The return on capital requirements should be appropriate for the current status of the Enterprises rather than a theoretical future state.

4. Numerous analyses suggest that current levels of pricing, as well as proposed levels, are excessive. Particularly troubling from the standpoint of access to credit is that pricing for higher LTV borrowers does not adequately consider private mortgage insurance. The concurrent proposal to increase private mortgage insurers' capital requirements will only magnify what appears to be several layers of cost covering the same risks.

5. To obtain the best possible input from external sources through an RFI of this nature, FHFA should provide more transparency regarding the risk models that it is using. While a number of analysts have attempted to reverse engineer FHFA's models, it makes much more sense for FHFA to make its assumptions transparent so they can be properly examined.

Below are more specific answers to the questions posed.

Questions

1. *Are there factors other than those described in section III – expected losses, unexpected losses, and general and administrative expenses that FHFA and the Enterprises should consider in setting g-fees? What goals should FHFA further in setting g-fees?*

We agree with the broad premise that g-fees should be based on economic assumptions around the listed factors. We also believe that there are quite a number of other factors or considerations that we believe FHFA and the Enterprises should and should not take into account in setting g-fees.

Most broadly, the Enterprises operate under a public charter that charges them with "…providing ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities)…"[4] In setting g-fees, FHFA should evaluate any decisions against this mandate first and foremost.

Second, we think FHFA should factor in both the cost of and credit enhancement provided by private mortgage insurance. Unlike fully private financial institutions, GSE charters require that loans below 80 percent LTV carry credit enhancement. In a separate Request for Input, FHFA has shared proposed requirements for private mortgage insurers that are intended to reduce counterparty risk for the GSEs. Because low down-payment borrowers are often lower-income, lower-wealth, and/or people of color, FHFA policies that influence private mortgage insurance pricing have a significant impact on these populations, which are the populations most crucial for creating a healthy housing market in decades to come. Decisions concerning g-fees must be made in close coordination with decisions regarding PMI requirements, especially when considering the tension between risk-based pricing and average pricing.

Third, in setting the size of the g-fee, FHFA should consider prepayment speeds as well as losses. It is well known that borrowers with higher credit scores and lower LTVs have higher prepayment speeds than those on the other end of the spectrum. This difference in prepayment speeds has long been

[4] Sec 301(3) Fannie Mae Charter Act

recognized by the Enterprises as an important factor when they are bundling pools of mortgages into securities, and it should also be a factor in determining g-fees.

Fourth, we suggest FHFA consider the distinction between purchase loans and refinancings. As Michael Molesky and Mark Goldhaber describe in detail in their response to the Request for Input, these two categories of loans have significantly different loss rates.[5] This difference matters most for aspiring first-time home buyers, who are more likely to seek lower down-payment loans than borrowers who have benefited from price appreciation and equity accumulation when seeking to refinance a current loan or purchase a home that is not their first. If the GSEs are to serve the market as broadly as possible, bifurcating the g-fee analysis could result in significantly lower costs for those purchasing a home and make an important contribution to achieving their mission purposes. Making the distinction between purchase and refinancing was a helpful change that was made to the affordable housing goals and will be equally helpful here.

Finally, we strongly oppose using g-fee pricing to raise revenue for other purposes, such as when Congress used it to replace lost federal revenue through the payroll tax suspension. As we discuss below at greater length, we also do not believe that g-fees should be set in order to "crowd in" private capital by raising the cost of a federal guarantee beyond what is necessary to assure the market's smooth and stable functioning and the Enterprises' full ability to make good on credit guarantees in force.

2. *Risk to the Enterprises increases if the proportion of higher-risk loans increases relative to the proportion of lower-risk loans. This change in mix can occur if lower-risk loans are retained on bank balance sheets instead of being sold to the Enterprises, if more higher-risk loans are sold to the Enterprises, or if the overall mix of originated loans changes. What alternatives, other than risk-based pricing, should be considered? What are the pros and cons of each alternative?*

In our view, government-sponsored enterprises exist to support a liquid and stable market across all geographies, vintages, business cycles, and populations, and we believe this is best accomplished through the GSE's unique ability to pool risk and price their credit guarantee across these pools and vintages. The GSEs took this approach before conservatorship.

The alternative – loan-level, risk-based pricing – is inherently pro-cyclical rather than stabilizing. During stressful periods, prices will increase just when the market requires liquidity the most. Additionally, by making loans more expensive for borrowers with certain risk characteristics, risk-based pricing may itself contribute to making those loans inherently riskier because a more expensive mortgage will be more difficult to sustain over time.

GSEs currently limit their risk by having a large and diversified asset base and operating with strong underwriting standards that are reinforced by the Dodd-Frank Act mortgage provisions. It makes sense for them to use their current market dominance with its large asset base and high level of liquidity to smooth out the tails on the curve with products that are standardized, highly diversified, and predictable through the credit cycle, and pricing that will contribute to borrower success rather than failure.

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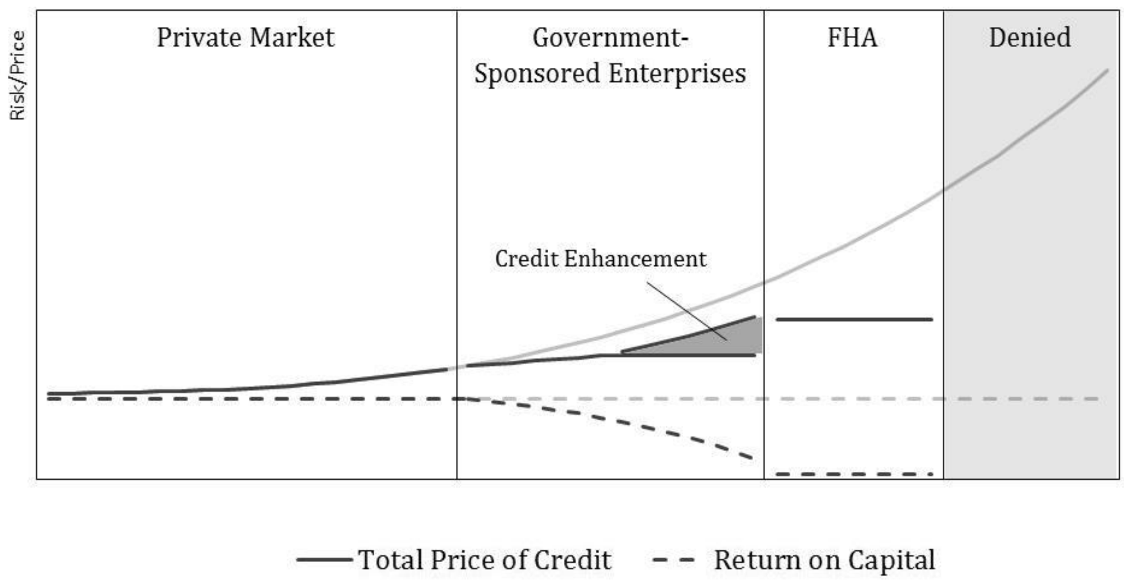
[5] Mark Goldhaber and Michael Molesky, "Fannie Mae and Freddie Mac Guarantee Fees: Request for Input" (2014), available at http://www.goldhaberps.com/wp-content/uploads/2014/08/G-Fee-Comment-Letter-PDF-8-26-2014-11am.pdf

More specifically, the GSEs should aim to serve the broad middle of the market and price accordingly. If banks are contributing to systemic risk by the way they select which loans to hold on balance sheet, that is a matter FHFA should take up with their regulators. However, as we discuss in more detail below, by and large we believe the Enterprises should aim for the middle position in the mortgage market risk-and-price continuum, sitting between the purely private market on the one hand and the Federal Housing Administration on the other.

In its answer to this Request for Input, the UNC Center for Community Capital presents this concept in an elegant chart that we have reproduced here. This chart illustrates how "government-supported housing finance agencies can bend the risk-based pricing curve, and used pooled, average pricing without incurring destabilizing adverse selection."



3. *Currently, target return on capital and the amount of capital largely determine required g-fees. What factors should FHFA and the Enterprises consider in setting target return on capital and amount of capital required? How should the Enterprises allocate capital across risk buckets?*

The target return on capital and the capital level required, when combined with information about aggregate risk, determine the total amount of fees that the Enterprises must collect, making these questions of paramount importance.

(1) Target return on capital

In considering how to set the target return on capital, FHFA should strongly weight the fact that the Enterprises are currently in conservatorship with no immediate exit strategy in sight. The U.S. Treasury is currently the only recipient of any return on the Enterprises' capital through the sweep provisions in the Third Amendment to the PSPAs. Moreover, the PSPAs and conservatorship strictly limit the amount of capital the Enterprises are permitted to hold.

In the Request for Input, FHFA used sample targets of 9 percent and 15 percent after-tax returns. If the Enterprises were operating under normal circumstances, i.e., if they were not in conservatorship, an after-tax return of 9 percent might be an appropriate level, although it is still high relative to the return that other institutions such as banks receive on their mortgage business alone, or the level earned by the Federal Home Loan Banks, for example. An after-tax return of 15 percent seems excessive even in normal circumstances, running contrary to the public mission of the Enterprises.

Under the conservatorship, we believe a significantly lower return on capital is appropriate, with the lower bound of the range being just above the ten-year Treasury bond. As noted above, now is the time for FHFA and Treasury to prioritize strengthening and growing the mortgage market so that it can be weaned off its current life support and proceed in a healthy way going forward. The lower return will allow for more affordable mortgages, thereby achieving that goal. When GSE reform or another resolution of the conservatorship does occur, we consider it virtually certain that there will be a long transition period, during which target return levels can rise to more of a market level.

(2) Capital Levels Required

It is challenging to consider how to set capital levels for the GSEs. The so-called "fair value" accounting approach advocated by some does not make sense, given that the GSEs are unlike any other private financial institution. For example, it is impossible to benchmark conforming loans against jumbo loans, as the products have a very different profile. Similarly, benchmarking against banks makes little sense for monoline, non-depository institutions. As the Urban Institute has argued, "Banks take risks that put them in a very different position than the GSEs. For example, banks often lend to businesses on an unsecured basis—an activity that is an order of magnitude more risky than making secured loans to borrowers who put down at least 20 percent or whose loans are covered by mortgage insurance. And even if a bank did exclusively mortgage lending and held those loans in portfolio, its risk would not be nearly as geographically diverse as that of the GSEs."[6] Under the conservatorship, given the explicit government guarantee, the most similar institution is actually another government agency, the Federal Housing Administration, whose required capital ratio is two percent (with no required return).

Most important, however, is that FHFA and the Enterprises use the appropriate assumptions in setting the g-fee to achieve both the target return on capital and the capital levels required. Analyses presented by Molesky and Goldhaber and by the Urban Institute suggest that FHFA should refine their assumptions before finalizing any guarantee fee changes.

Molesky and Goldhaber identify a number of concerns regarding the assumptions, the two most important of which are the differences in loss rates between purchase loans and refinancings and the decision to use a singular year (2007) for a stress scenario rather than a series of years.[7] Using a more realistic composite portfolio with multiple years' worth of business, even when severely stressed, substantially reduced the amount of capital cushion required. What's more, it's not clear if the stress

[6] Laurie Goodman, Ellen Seidman, Jim Parrott, and Jun Zhu, "Guarantee Fees —An Art, Not a Science," (Urban Institute, 2014), available at http://www.urban.org/UploadedPDF/413202-Guarantee-Fees-an-Art-Not-a-Science.pdf

[7] Goldhaber and Molesky, "Fannie Mae and Freddie Mac Guarantee Fees: Request for Input"

scenario from 2007 considers only loans that would fit current underwriting requirements under the Dodd-Frank Act mortgage provisions (Ability to Repay/Qualified Mortgage).

The Urban Institute identifies a number of additional concerns about the assumptions as well, and we refer you to their comment for more details. Specifically, they discuss the failure to consider future g-fee premiums as capital, which has significant effects on guarantee fees, and the importance of allocating capital associated with macroeconomic stress rather than expected loss equally to all FICO/LTV buckets.[8]

4. *At what g-fee level would private-label securities (PLS) investors find it profitable to enter the market or would depository institutions be willing to use their own balance sheets to hold loans? Are these levels the same? Is it desirable to set g-fees at PLS or depository price levels to shrink the Enterprises' footprints, even if this causes g-fees to be set higher than required to compensate taxpayers for bearing mortgage credit risk and results in higher costs to borrowers?*

We do not believe it is appropriate or necessary to manipulate guarantee fee levels in pursuit of some market sizing objective with respect to private mortgage capital investors. The desire to "crowd in" private capital has driven FHFA in the past several years to raise g-fees well above the level that required by the current risk levels.[9] In considering that desire, first it is important to distinguish between different types of private capital.

In terms of private-label securitization, we have seen extremely little change even as g-fees have doubled. In our view, the g-fee is not the primary reason that PLS securitization remains moribund. Rather, it's the continued uncertainty regarding the future of the government guarantee and the concern that many of the misaligned incentives that caused the crisis and that resulted in investor losses have not been adequately addressed by Congress, regulators, and the Wall Street infrastructure.

While increased guarantee fees have created an uptick in the willingness of depository institutions to hold loans on balance sheet, they choose to retain only the least risky loans, thereby increasing risk to the GSEs through adverse selection (which also might be the case if PLS securitization were to return). Furthermore, the banks' own capital rules and Federal Reserve monetary policy may have as much if not more influence on balance sheet lending than g-fee levels.

Ironically, the main effect of the attempt to crowd in private capital has been a significant crowding in of public capital, as the high fees associated with conventional financing push a larger volume of borrowers to an FHA execution. In this case, the private capital that is the private mortgage insurance business is detrimentally affected.

In short, we are confused by the desire to crowd in private capital. There is no part of the FHFA authorizing statute or the GSE charters that confers upon these institutions a duty to facilitate purely private activity in the mortgage market. Yet there is a duty to support a liquid and stable market across all geographies at all times, which is a mission best accomplished with a larger rather than a smaller market share. Looking at it that way, pricing too high may in fact violate the charters.

5. *If the Enterprises continue to raise g-fees, will overall loan originations decrease? That is, will Enterprise loans decline without a commensurate increase in private capital?*

[8] Goodman et al., supra note 6.
[9] Ibid.

Overall loan originations are already at their lowest level in 17 years.[10] Especially in a situation where it is unlikely that the purely private sector will provide significant additional liquidity and a virtual certainty that it will not provide that liquidity to the geographies and populations where borrowing is most constrained, it follows that unnecessarily raising prices will do little but further depress total conventional, conforming originations.

6. *Is it desirable for the Enterprises to charge higher g-fees on low credit score/high LTV loans if it causes these loans to be insured/securitized through FHA/Ginnie Mae rather than through the Enterprises?*

As we expressed above, we believe the GSEs should pool risk and average price as much as possible, and that they should not charge significantly higher g-fees for lower credit scores and higher LTV loans. If they follow that course, many more people will have access to conventional financing than is the case at present, which will likely reduce the FHA footprint.

Because some groups of borrowers will always be more profitable than others, the GSE charters specifically state that it is appropriate for the companies to accept a smaller profit when necessary to reach underserved markets. One of the most important reasons for this direction is the undesirability of a "dual market" where the GSEs serve higher-income, higher-wealth, whiter borrowers and FHA serves lower-income, lower-wealth, and browner borrowers. Competition between these two parts of the system is important to keep the market operating safely and honestly, and American history is rife with examples that "separate but equal" is never equal.

However, just as we do not consider it appropriate for FHFA or the GSEs to attempt to crowd in private capital by unnecessarily raising g-fees, we do not consider it appropriate for them to select a footprint for FHA and aim for that goal either by raising or lowering fees. Rather, they should lend to as large a continuum of borrowers as they can do safely and fairly. The borrowers who cannot access conventional financing or who can access it more inexpensively at FHA will flow to that execution.

7. *Is it desirable for the Enterprises to (a) charge higher g-fees on high credit score/low LTV loans if it causes these loans to be insured/securitized through PLS or (b) held on depository balance sheets, rather than guaranteed by the Enterprises?*

As noted above, our view is that the Enterprises should price according to their mission. Of course there is an upper bound above which they will lose some of the advantages of average pricing, and that will be an important consideration in figuring how best to pursue their mission. Their mission is neither to dominate all conventional conforming liquidity nor to cede the largest possible market share to other players based on some policy objective. Their mission is to support a broad and stable market through all of their standardization, liquidity and funding authorities, with particular attention to the needs of lower- and moderate-income borrowers. As in the past, a well-priced g-fee structure will lead to a mixed market with a combination of Enterprise, portfolio and private securities executions to meet the nation's mortgage finance needs. Setting appropriate requirements for credit loss and return on capital, combined with pooling risks and pricing across their portfolios, will allow the GSEs to maintain a

[10] Kathleen M. Howley, Zachary Tracer and Heather Perlberg, "Lending Plunges to 17-Year Low as Rates Curtail Borrowing" *Bloomberg*, April 14, 2014, available at http://www.bloomberg.com/news/2014-04-14/lending-plunges-to-17-year-low-as-rates-curtail-borrowing.html

"benchmark" credit guarantee fee that will both encourage and set boundaries on competitive executions.

8. *What approaches or alternatives should FHFA consider in balancing increased use of risk-based pricing with the HERA mission requirements of (1) liquid national housing markets and (2) acceptability of lower returns on loans made for low- and moderate-income housing?*

As noted above, FHFA should aim for as much risk pooling as possible, pricing across both pools and vintages. Again, prior to the institution of the current grids, Fannie Mae and Freddie Mac largely charged a uniform g-fee. Although it was relatively opaque and was actively used to manage market share against each other and other players, this system worked relatively well for many decades, with the Enterprises maintaining their position in the middle of the market between the purely private sector on the one hand and FHA on the other.

What's more, because of the credit enhancement requirement for over 80 percent LTV loans, many higher LTV loans pose less total credit risk for the Enterprises than lower LTV loans. Where potential loss severities are mitigated by first loss MI coverage that is mandated and paid for by consumers, the basic guarantee fee should reflect that risk sharing. Neither the proposed nor current g-fee structure adequately recognizes private mortgage insurance.

Given that private mortgage insurers will likely themselves engage in a combination of risk-based and competitive pricing against other insurers, FHFA should help the Enterprises balance out that tendency to avoid volatility and pro-cyclicality.

9. *Are the ranges of credit score and LTV cells in the proposed credit score/LTV grids used to set upfront delivery-fees and loan level pricing adjustments appropriate? Should any of the ranges be broader or narrower and, if so, why?*

We strongly encourage the fewest and most bright-line buckets be used for risk-based pricing. Limited buckets with clear definition will provide the important benefit of transparency and allow borrowers to comparison shop and better understand their loan pricing. Standard cells such as owner-occupied versus investor and distinctions between purchase and refinancing should also be implemented so as to not bog down the owner-occupied purchase market. We suggest eliminating buckets based on borrower characteristics such as credit score. The LTV-based pricing, as noted, should be left to the mortgage insurance pricing and coverage level.

10. *Should risk-based pricing be uniform across the Enterprises or should each Enterprise manage its own pricing?*

Again, we believe both Fannie Mae and Freddie Mac should risk pool. While under conservatorship, it makes sense to require the same capital and return-on-capital assumptions for calculating appropriate fees.

11. *Taking into consideration that FHFA has previously received input on state-level pricing adjustments, do the g-fee changes proposed in December 2013 have any additional implications that should be considered in deciding whether to price for the length of state foreclosure timelines, unable to market periods or eviction timelines? Are there interactions with other pricing*

components under consideration that FHFA should consider in making decisions on the state-level adjustments?

We previously submitted input on the question of state-level pricing adjustments in which we put forward a number of reasons to oppose such pricing adjustments. Differential pricing of risk based on geography runs contrary to the mission and indeed the core raison d'etre of the Enterprises, which is to stabilize the market across geographies and time rather than to feed into and exacerbate cycles. The proposal would instead have a strong pro-cyclical effect.

It is also instructive to note that since the time this policy was first proposed, some states that had extremely short timelines, such as Nevada, now have much longer delays.[11] These delays are a hangover from the crisis and from continued federal, state and local efforts to prevent foreclosures, representing an ever-shifting target that is an utterly inappropriate basis on which to make loan origination pricing decisions that have long-term horizons.

12. *Are there interactions with the Consumer Financial Protection Bureau's Qualified Mortgage definition that FHFA should consider in determining g-fee changes?*

Even when the Enterprises are using the "patch" permitted by the CFPB to use compensating factors rather than use the hard 43 percent DTI cut-off that others must use, the CFPB rules help ensure extremely high quality underwriting that will significantly reduce risk. As noted above, the QM definition therefore pushes toward lower rather than higher g-fees.

We will also note that because FHA has the authority to determine its own Qualified Mortgage definition, this definition may at times be a factor along with g-fees in determining the best execution for borrowers as between FHA and the conventional conforming market.

Thank you again for the opportunity to comment.

Sincerely yours,

Center for American Progress

Consumer Federation of America

Mortgage Finance Working Group

[11] Realtytrac, "U.S. Foreclosure Activity Decreases 10 Percent in February From January Jump to Lowest Level in More Than 7 Years," Press Release, March 11, 2014, available at http://www.realtytrac.com/content/foreclosure-market-report/realtytrac-february-2014-us-foreclosure-market-report-7997