



August 14, 2014

**BY ELECTRONIC SUBMISSION**

Federal Housing Finance Agency  
Office of Policy Analysis and Research  
Constitution Center  
400 7th Street, SW, Ninth Floor  
Washington, D.C. 20024

**Re: Request for Input – Enterprise Guarantee Fees**

Ladies and Gentlemen:

U.S. Mortgage Insurers (“USMI”) is a trade association composed of the following private mortgage insurance companies: Arch Mortgage Insurance Company, Essent Guaranty, Inc., Genworth Financial, Mortgage Guaranty Insurance Corporation, National Mortgage Insurance Corporation, and Radian Guaranty Inc. USMI welcomes the opportunity to submit comments on the request for input (“RFI”) by the Federal Housing Finance Agency (“FHFA” or “Agency”) regarding the guarantee fees (“g-fees”) that Freddie Mac and Fannie Mae (the “Enterprises”) charge to lenders.<sup>1</sup> The RFI follows FHFA’s suspension in January 2014 of increases to g-fees proposed by the Agency.<sup>2</sup>

USMI appreciates FHFA’s willingness to seek input about key matters affecting the Enterprises and the U.S. housing market. G-fees warrant robust public comment and discussion given their significant impact on U.S. homebuyers, the Enterprises, and other housing market stakeholders. Consideration of the terms of g-fees through a process like this RFI will help ensure that g-fees are calibrated to best further the Enterprises’ statutory mandates to provide stability in the secondary market for residential mortgages, respond appropriately to the private capital market, provide ongoing assistance to the secondary market for residential mortgages, and promote access to mortgage credit throughout the United States.

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<sup>1</sup> See FHFA Fannie Mae and Freddie Mac Guarantee Fees: Request for Input, p. 3 (June 5, 2014).

<sup>2</sup> See FHFA News Release, FHFA Directs Fannie Mae and Freddie Mac To Delay Guarantee Fee Changes (Jan. 8, 2014), *available at* <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Directs-Fannie-Mae-and-Freddie-Mac-To-Delay-Guarantee-Fee-Changes.aspx>.

As a threshold matter, USMI believes that FHFA should formally withdraw the proposed g-fee increases announced by FHFA on December 9, 2013.<sup>3</sup> On that date, FHFA directed the Enterprises to adjust g-fees in three ways: (1) the ongoing g-fee for all mortgages was to increase by 10 basis points; (2) the upfront g-fee grid would be updated to align pricing with credit risk characteristics of the borrower; and (3) the upfront 25 basis point adverse market fee imposed since 2008 would be eliminated except in four states. These g-fee changes were suspended by FHFA pending further review. Given FHFA's intention to set g-fees in a manner informed by the public comments received from this RFI, we see no reason why the proposed increases in December 2013 should be retained. Indeed, they should be withdrawn formally to make clear to the U.S. housing market that they will not become effective.

In addition, while the framework for calculating g-fees in the RFI is intended to price actual credit risk, USMI believes it fails to fully take into account the risk-reducing benefits of private mortgage insurance ("MI") and results in consumers being charged twice for the same risk reduction. This disproportionately disadvantages low- and moderate-income and first time homebuyers. MI is a well accepted and well regarded form of credit enhancement that has made homeownership possible for millions of people who otherwise would not have qualified for mortgage loans.

As described in greater detail on pages 4 and 5 of this letter, it is apparent that the benefits of MI are not fully incorporated in the RFI framework. For example, in certain instances, the Enterprises charge more in g-fees for their *second* loss position than private mortgage insurers charge for their *first* loss position. In other cases, g-fees charged on loans with MI are too high relative to the g-fees charged by the Enterprises on loans demonstrating increased risk, such as loans with piggyback second mortgages. The framework should fully take into account MI's risk-reducing benefits in order to accurately and completely reflect the economics of the mortgage transaction to the Enterprises. MI significantly reduces credit risk exposure to the Enterprises and shifts the first-loss exposure from taxpayers to private market participants. Indeed, Congress intended for the Enterprises to incorporate MI into their business model by requiring, in the Enterprises' statutory charters, some form of credit enhancement for purchased or securitized loans with loan-to-value ratios ("LTVs") in excess of 80 percent.<sup>4</sup> The failure to fully reflect the risk mitigating benefits of MI in the Enterprises' framework for establishing g-fees would not only double charge consumers, but also would undermine the clear congressional intent for the Enterprises to require credit enhancement on loans with LTVs above 80 percent.

Finally, FHFA should not increase g-fees in order to attempt to "crowd in" private capital and shrink the Enterprises' footprints. Private label securities ("PLS") historically have been an unreliable source of liquidity in times of economic stress. In addition, increasing g-fees in this manner would result in increased costs to borrowers and potentially other unintended

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<sup>3</sup> See FHFA News Release, FHFA Takes Further Steps to Advance Conservatorship Strategic Plan by Announcing an Increase in Guarantee Fees (Dec. 9, 2013), available at <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Takes-Further-Steps-to-Advance-Conservatorship-Strategic-Plan-by-Announcing-an-Increase-in-Guarantee-Fees.aspx>.

<sup>4</sup> See 12 U.S.C. §§ 1454(a)(2); 1717(b)(2).

consequences. In the absence of a mandate to use g-fees to attempt to crowd in private capital, there is no justification for such increased costs or other unintended consequences.

By not fully recognizing MI, unnecessarily high g-fees for high LTV loans would be charged to lenders, which would in turn pass all or a substantial part of such excess cost on to borrowers – thereby raising the cost of credit for a sizeable segment of U.S. homeowners and homebuyers. As described in detail below, USMI strongly believes that, because MI reduces the risk of loss to the Enterprises, the g-fees charged for mortgages delivered by lenders with MI before the GSEs provide their guaranty should be commensurately reduced.

The remainder of this comment letter responds to three specific questions in the RFI.

***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?***

The RFI's framework for calculating g-fees – based on the cost of capital, the potential for losses, and expenses<sup>5</sup> – is a standard approach to pricing credit risk recognized in the capital markets and financial and banking industries. Indeed, a version of this approach is used by the mortgage insurers that make up USMI. At the same time, however, the details of such an approach can vary significantly, producing very different results in terms of g-fees charged and the cost of credit. As a result, quite apart from our substantive comment below about other factors that should be considered in setting g-fees, USMI strongly believes that there should be significantly greater transparency with respect to the Enterprise models (the analytical framework, its assumptions, and its inputs) that are used for pricing and to compute g-fees because these models have an extraordinary impact on the U.S. housing market. Disclosing the specific parameters of the models used and soliciting public input regarding the parameters would be a helpful first step in maximizing these models' ability to efficiently set g-fees.

The models influence FHFA assessments and Enterprise decision-making. Without understanding the models, it is difficult to assess the reasonableness of g-fees under the RFI. Aspects of the model that might be considered relatively minor can have a major effect on the costs of credit and allocation of those costs to borrowers and lenders. It has become clear to the industry that, prior to the proposed g-fee increases in December 2013, substantial changes were made to the Enterprises' models without explanation to the housing market. While changes to g-fees did not become effective, they would have resulted in a material increase in mortgage credit costs. Such a significant change should not occur without notice and public comment supported by a high level of transparency. For these reasons, FHFA should require increased transparency of the models that are used to compute g-fees.

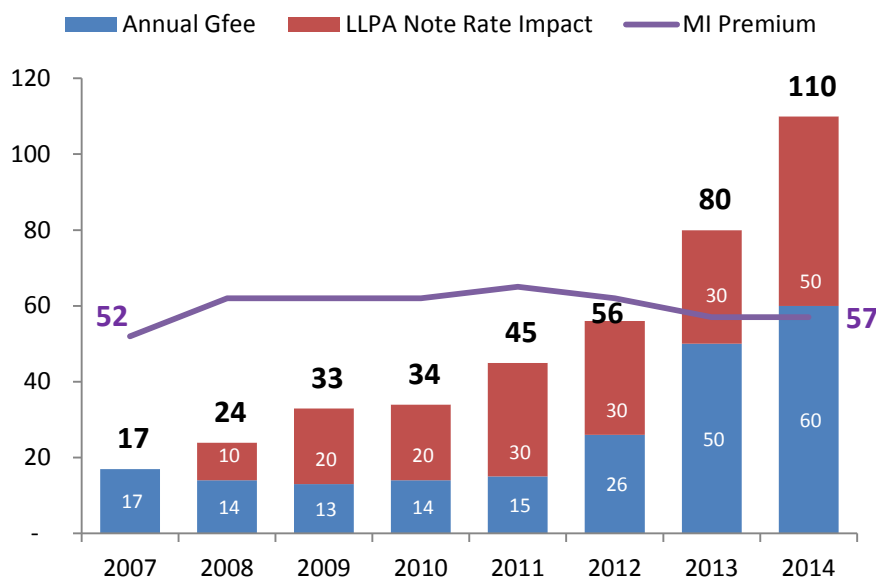
With respect to whether other substantive factors should be taken into account in setting g-fees, USMI strongly believes that the Enterprises should fully incorporate the plainly risk-reducing effect of MI. This form of credit enhancement is typically obtained by low- and

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<sup>5</sup> See RFI, p. 3.

moderate-income and first time homebuyers who have steady employment and income, but do not have funds available for a down payment of 20 percent or more.

It is critical that FHFA, in computing g-fees, correctly incorporate the impact of MI in reducing the Enterprises’ estimated costs of providing a credit guarantee. To do otherwise results in consumers being charged twice for the same risk reduction, which disproportionately disadvantages low- and moderate-income and first time homebuyers. However, it is apparent from information in the RFI and elsewhere that the Enterprises are not appropriately taking MI into account, thereby significantly discounting MI’s risk mitigation benefits. For example, the g-fees charged by the Enterprises for a loan with a greater than 80 percent LTV and MI are plainly too high: in some instances, the Enterprises charge more in g-fees for their *second loss* position than private mortgage insurers charge for their *first loss* position. The following chart illustrates this disparity for a loan with a 90 percent LTV and a borrower with a 680 FICO score.



Sources: FHFA’s Fannie Mae and Freddie Mac Single-Family Guarantee Fees In 2012; Fannie’s LLPA by Credit Score / LTV; SEC Reports; Genworth rate filings & estimates; includes the 10 basis point base g-fee assessed to cover the 2011 payroll tax cut extension (effective April 2012)

Moreover, alternatives to avoid MI are not priced in the same fashion. For example, a “piggyback” mortgage is a second lien loan originated simultaneously with a first lien mortgage that technically has an LTV of 80 percent or less. The g-fees charged on a piggyback loan are modest (as little as 75 bps in upfront fees based on the borrower’s FICO score), even though loans with piggyback seconds have the potential to represent much greater credit risk since the first lien may not take the piggyback loan into account in the underwriting process. In essence, the piggyback mortgage is provided to fund some part of the borrower’s down payment, which means that the borrower has less “skin in the game” than would be the case if the full 20 percent down payment were provided from the borrower’s own resources. It is well documented that first mortgages originated with such “simultaneous second mortgages” sustained an outsized

amount of defaults and losses during the financial crisis and required separate operational adjustments by servicers to provide foreclosure relief to borrowers.<sup>6</sup>

In addition, in the white paper released in conjunction with the private mortgage insurer eligibility requirements (“PMIERS”), FHFA disclosed that funds projected to be due to the Enterprises from MI claims are “haircut” by 20 and 25 percent due to the risk that the insurer fails to meet its obligations or denies the claims, but there is no similar treatment of second liens.<sup>7</sup> As further discussed below, this haircut is not justified. If the haircut is factored into the setting of g-fees for loans with MI, it unnecessarily increases costs for low down payment borrowers.

All of these examples demonstrate that the Enterprises are not fully incorporating MI into its analytics, including those that are used to compute g-fees. USMI believes there are compelling reasons to give full recognition to MI going forward:

- In the past several years, private mortgage insurers have become substantially stronger – increasing their capacity to withstand losses while paying claims on defaulted mortgages – through substantial recapitalization achieved through the retention of significant premium revenue and an infusion of approximately \$9 billion in new private capital, including in the form of three new market entrants.
- As part of an FHFA/Enterprise initiative to enhance the standards applicable to private mortgage insurers, new MI master policies will become effective October 1, 2014, that will increase clarity, reduce ambiguity, and enhance the insurance protection provided to policyholders.<sup>8</sup>
- Under FHFA’s direction, the Enterprises published a draft of new comprehensive PMIERS that set standards that will help provide confidence to market participants and policymakers regarding the long-term value of MI, and, once finalized, the Enterprises will oversee private mortgage insurers’ compliance with these standards.
- Enhanced underwriting rigor and fully documented lending practices in the lending industry, driven in part by the need to comply with the ability-to-repay rules,<sup>9</sup> will make mortgages considerably less susceptible to the risk that

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<sup>6</sup> See Federal Reserve Bank of New York Staff Report, A New Look at Second Liens (Aug. 2012), and [http://www.makinghomeaffordable.gov/programs/lower-payments/Pages/lien\\_modification.aspx](http://www.makinghomeaffordable.gov/programs/lower-payments/Pages/lien_modification.aspx).

<sup>7</sup> See Robert M. Dunskey et al., FHFA Mortgage Analytics Platform, p. 24-25 (July 10, 2014).

<sup>8</sup> See, e.g., Fannie Mae, Fannie Mae Announces Approved Mortgage Insurance Forms (June 24, 2014).

<sup>9</sup> See Consumer Financial Protection Bureau, Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act, 78 Fed. Reg. 6408 (Jan. 30, 2013).

mortgage insurers will refuse to pay claims where mortgages default based on borrower misrepresentation or the failure of the mortgage lender to comply with its contractual obligations.

In sum, USMI recommends that the Enterprises fully reflect MI's risk mitigation benefits in calculating g-fees on loans with MI. Doing so will reduce the cost of mortgage credit and incentivize the use of private capital in a first loss position ahead of taxpayers. In addition, taking MI into account should reduce the amount of credit risk retained by the Enterprises and increase the amount of credit risk that is retained by private market participants and is therefore subject to competitive market-based pricing.

**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 response to question 1 above provides information responsive to this question as well. In sum, FHFA and the Enterprises should take into account whether a mortgage loan has MI in setting metrics such as return on capital and amount of capital that ultimately are used to compute g-fees.

In addition, USMI recommends that the Enterprises calculate capital requirements and the cost of capital separately for loans with and without up-front first-loss credit enhancement such as MI. It follows that a mortgage transaction with a more remote risk of loss should have lower economic capital and rates of return on capital than a similarly situated mortgage transaction with a less remote risk of loss. The transaction with the more remote risk of loss should have lower g-fees, just as the senior tranches of a mortgage backed security are priced to reflect a lower risk of loss.

Provided the Enterprises' method for computing g-fees is revised to incorporate MI, a framework linking pricing to the credit risk assumed by the Enterprises (including the likelihood of risk of loss to the Enterprises) should have the straightforward effect of encouraging additional upfront transfers of credit risk from lenders to private market participants rather than to the Enterprises, thereby reducing risk to U.S. taxpayers. If the Enterprises fail to make clear to the market in computing g-fees the connection between pricing and credit risk, they will correspondingly fail to establish clear incentives for the market to make use of private capital.

**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?***

Increasing g-fees would *not* be effective in "crowding in" private capital, and there are strong policy reasons *not* to use g-fees in this way to shrink the Enterprises' footprints:

- The PLS markets have been notably unreliable in times of economic stress.<sup>10</sup>
- Depository institutions increasingly have held mortgages on their balance sheets, but their appetite for doing so is limited in part because 30-year fixed-rate mortgages present a significant asset-liability maturity mismatch problem.
- Increasing g-fees to crowd in private capital will increase costs to borrowers, thereby constraining access to credit.
- Government mortgage insurance programs administered by the Federal Housing Administration (FHA), Department of Veterans’ Affairs (VA), and Rural Housing Services (RHS) have become options of first resort for an increasing number of borrowers who cannot make a 20 percent down payment. The attractiveness of these programs will continue to increase if increased g-fees are passed along to borrowers who have the resources to pay MI in lieu of making a 20 percent down payment.
- FHFA is not subject to a mandate to use g-fees to attempt to crowd in private capital.

Accordingly, USMI recommends that the g-fees not be increased in an effort to move mortgages away from the Enterprises. The costs for borrowers would be too great, and the result of shifting guarantees from the Enterprises to government agencies such as FHA and VA would run contrary to public policy.

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In sum, it is critical that FHFA fully incorporate the impact of MI in reducing the Enterprises’ estimated costs of providing a credit guarantee in computing g-fees. To do otherwise results in consumers being charged twice for the same risk reduction and disproportionately disadvantages low- and moderate-income and first time homebuyers.

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<sup>10</sup> On June 26, 2014, the U.S. Department of the Treasury (“Treasury”) requested public comment on the role of the PLS market in the U.S. housing finance system. *See* 79 Fed. Reg. 36872 (June 30, 2014). Treasury materials released in conjunction with the request for public comment acknowledged the unavailability of PLS markets following the financial crisis. “[M]any of the largest [PLS] investors have not returned to the market, resulting in very little issuance and few mortgage financing options for borrowers aside from government-supported channels.” *See* Treasury Press Release, Secretary Lew Unveils New Efforts to Assist Struggling and Prospective Homeowners, Provide More Affordable Options for Renters (June 26, 2014), *available at* <http://www.treasury.gov/press-center/press-releases/Pages/jl2444.aspx>.

USMI appreciates the opportunity to comment on FHFA's RFI. Questions or requests for further information may be directed to the co-chairs of USMI, Rohit Gupta and Adolfo Marzol, at [info@usmi.org](mailto:info@usmi.org).

Sincerely,

**U.S. Mortgage Insurers**