RESULTS OF FANNIE MAE AND FREDDIE MAC GUARANTEE FEE REVIEW

SUMMARY

The Federal Housing Finance Agency (FHFA) has completed a comprehensive review of the agency's policy for guarantee fees charged by Fannie Mae and Freddie Mac (the Enterprises). FHFA's review considered multiple factors, including responses to the agency's June 2014 request for public input, analyses by housing finance market participants of the implied guarantee fee pricing from the Enterprises' credit risk transfers, and internal analyses of Enterprise pricing, credit guarantee loss data, and modeling.

FHFA's review focused on reaching an appropriate balance between FHFA's statutory obligations to: 1) ensure the safety and soundness of the Enterprises, and 2) foster a liquid national housing finance market. In light of this balance, FHFA determined, based on both internal and external analysis, that the current average level of guarantee fees appropriately reflects the current costs and risks associated with providing the Enterprises' credit guarantee.

As a result, FHFA finds no compelling economic reason to change the general level of fees. FHFA, however, is making certain minor and targeted fee adjustments. To implement these decisions, the agency is directing the Enterprises to make changes to their guarantee fees that will slightly reduce, maintain, or increase costs for different categories of loans. Since all of the guarantee fee changes are small, the agency does not expect the adjustments to cause any material changes to the Enterprises' loan volume in any of the loan categories and expects the small changes to be revenue neutral.

The guarantee fee adjustments directed by FHFA fall into two categories:

- First, the foundational adjustment is removing the 25 basis point upfront adverse market charge. The Enterprises established this fee in 2008 as an on-top pricing increase to reflect the unfavorable condition of the national housing market at that time. FHFA believes it is appropriate to remove this housing crisis-era fee in light of improvements in the housing markets. The agency is also setting aside its December 2013 decision to retain the adverse market charge in certain states with higher than average foreclosure related costs.
- Second, the agency is applying targeted and small fee adjustments to a subset of Enterprise loans. This includes small fee increases for certain loans in the Enterprises' upfront loan-to-value (LTV) ratio/credit score pricing grid and for certain loans with risk-layering attributes (i.e., cash-out refinances, investment properties, loans with secondary financing, and jumbo conforming loans).

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HOW THE ENTERPRISES DETERMINE GUARANTEE FEES

The Enterprises acquire single-family loans from lenders and securitize them in the form of mortgage-backed securities (MBS). For investor-held MBS, the Enterprises guarantee timely payment of principal and interest to the investor. Guarantee fees cover three cost components that the Enterprises expect to incur in providing their guarantee. They are: 1) the expected costs that result from the failure of some borrowers to make their payments; 2) the cost of holding the modeled capital amount necessary to protect against potentially much larger unexpected losses that result from the failure of some borrowers to make their payments in a severe stress environment; and 3) general and administrative expenses. Collectively, these costs comprise the estimated cost of providing the credit guarantee.

Of these three components, the second (cost of capital) is by far the most significant. Despite the Enterprises' inability to retain capital under the Senior Preferred Stock Purchase Agreements (PSPAs) entered into with the U.S. Department of the Treasury in 2008, FHFA has established guarantee fee levels consistent with the amount of capital the Enterprises would need to support their guarantee businesses if they were not in conservatorship and retained capital.

HOW GUARANTEE FEES IMPACT BORROWERS

As compensation for providing the guarantee on MBS, the Enterprises charge lenders guarantee fees. The Enterprises charge lenders a base, or ongoing, fee that is primarily based on the product type (e.g., 30-year Fixed Rate, 15-year Fixed Rate, 5/1 ARM). The Enterprises also charge upfront guarantee fees, also known as loan level pricing adjustments (LLPAs) or delivery fees, that are based on certain risk attributes of the borrower or the loans (e.g., LTV/credit-score grid, cash-out refinance, investor properties, secondary financing at origination, jumbo conforming loan). While the Enterprises assess LLPAs or delivery fees as an upfront fee, most lenders convert them into the interest rate on the mortgage, which the borrowers pay over time, like ongoing guarantee fees.[1] Together, ongoing guarantee fees and LLPAs/delivery fees make up the Enterprises' total compensation for providing the credit guarantee. In addition, since 2008, each Enterprise has assessed an adverse market charge as a surcharge for challenging housing market conditions.

FHFA REVIEW OF CAPITAL ADEQUACY

In performing its review of guarantee fees, FHFA evaluated appropriate levels of required capital and target rates of return. In doing so, the agency reviewed Fannie Mae and Freddie Mac's capital and credit models. FHFA also independently compared the Enterprises' most recent loan acquisition profile with the actual losses experienced on similar loans from the recent crisis.

In addition, the agency considered analytical reports by firms in the financial services industry about the Enterprises' credit risk transfer transactions. The reports assess the implied level of guarantee fees based on the pricing of an early 2015 Freddie Mac credit risk transfer (STACR) transaction, and most conclude that the Enterprises' current level of fees is appropriate. Similarly, some public response letters and industry reports, which are based on the respondents' own capital and rate of return assumptions, asked FHFA to either maintain or modestly lower guarantee fees from their current levels.

As a result of FHFA's review of guarantee fee levels, the agency concludes that the current guarantee fee level is appropriate under current circumstances.

[1] As an example, the 25 basis point upfront adverse market charge is approximately equivalent to 5 basis points ongoing mortgage rate (or 0.05%).

ELIMINATION OF THE ADVERSE MARKET CHARGE

Each Enterprise instituted an adverse market charge in 2008 to compensate for their credit risk models not adequately assessing the extra costs and risks from the difficult market conditions and declining house prices at that time. That justification no longer applies. The housing market has improved significantly in recent years, and the Enterprises' credit risk models now incorporate the experience of the recent crisis.

As described above, FHFA's analysis concludes that the current average level of guarantee fees is appropriate based on current assessments of cost and risk. Because these average guarantee fees currently include the adverse market charge, removing this fee component necessitates other guarantee fee adjustments. As a result, FHFA is directing the Enterprises to replace the revenue attributable to the adverse market charge with targeted changes in fees that address various risk-based and access-to-credit considerations. Overall, FHFA expects these changes to be revenue neutral to the Enterprises based on their recent mix of business.

SET ASIDE OF STATE-LEVEL PRICING

When FHFA announced its decision to eliminate the adverse market charge in December 2013, the elimination was for all states except Connecticut, Florida, New Jersey, and New York. The adverse market charge would have been unchanged in those four states to compensate, approximately, for the difference in the foreclosure timeline related costs relative to average costs across the country.

Although foreclosure costs are significantly higher in these four states compared to other states, the agency is setting aside the previous decision to implement these geographically based fees. FHFA will explore opportunities to engage with states to better understand the reasons for longer foreclosure timelines and to share with states the cost implications to the Enterprises as well as potential impacts to borrowers. At the same time, FHFA will continue to work toward finding an appropriate balance between allowing sufficient time for borrowers to obtain loss mitigation alternatives and ensuring timely resolution of foreclosures.

TARGETED FEE ADJUSTMENTS

The decision to eliminate the adverse market charge yet maintain the overall average level of guarantee fees required a plan to recover this revenue. The set of targeted adjustments to guarantee fees described below only apply to the Enterprises' upfront fees and do not affect base, ongoing guarantee fees. The fee changes will become effective for loans delivered to the Enterprises beginning on September 1, 2015. The agency does not expect a material change in the Enterprises' loan volume as a result of these changes.

The targeted fee adjustments include the following categories:

- **LTV/Credit Score Grid**

  In the Enterprises' LTV/credit score grids, which apply to loans with terms exceeding 15 years, FHFA is directing the Enterprises to increase the upfront fees by 25 basis points for loans that have both an LTV ratio of 80 percent or less and credit-score of 700 or more.[2]

[2] Small exceptions: 1) the upfront fee is not being changed for one loan group (61-70% LTV/700-719 credit score), and 2) Fannie Mae is increasing upfront fees by 25 basis points for three additional loan groups (71-75% LTV/660-679 credit score, 76-80% LTV/660-679 credit score, 71-75% LTV/640-659 credit score) to align their pricing with Freddie Mac.

For loans that have an LTV ratio above 80 percent or a credit score below 700, FHFA is generally leaving the upfront fees the same.[3] As a result, these loans will receive the full benefit of the 25 basis point adverse market charge elimination. Contributing to the determination to leave the upfront fees the same for this LTV/credit score group is FHFA's separate action to finalize new standards for mortgage insurers – Private Mortgage Insurer Eligibility Requirements (PMIERs). Loans with less than a 20 percent down payment are required to have credit enhancement, which lenders typically satisfy with private mortgage insurance. FHFA anticipates that the finalized PMIERs will provide a modest cost savings to the Enterprises from reduced mortgage insurer counterparty exposure.

- **Cash-Out Refinances, Investment Properties, and Loans with Secondary Financing**

  FHFA is directing the Enterprises to increase guarantee fees on certain higher-risk loan types to improve risk-based pricing. Specifically, the agency is increasing fees by 37.5 basis points on cash-out refinances, investment properties, and loans with simultaneous secondary financing. Consistent with the practice today, when a loan falls into more than one category (e.g., both a cash-out refinance and investment property), the add-on fees are cumulative, which results in the net increase in those cases being higher than 37.5 basis points.[4]

- **Jumbo Conforming Loans**

  FHFA is directing the Enterprises to increase the fee on jumbo conforming loans (over $417,000) by 25 basis points. Congress allowed the Enterprises to acquire these higher balance loans in certain high cost areas of the country in response to the housing crisis.

ONGOING SAFETY AND SOUNDNESS OVERSIGHT

As part of our ongoing oversight of the Enterprises, FHFA collects data on new loan acquisitions, monitors changes in the composition of loan purchases, evaluates quality control activities, and assesses the implications of these and other factors for risk to the Enterprises and their level of guarantee fees. Since FHFA recognizes that market conditions affecting mortgage credit risk will change over time, the agency will continue to conduct these oversight activities. Should FHFA determine in the future that market conditions necessitate adjustments in guarantee fees to sustain the safety and soundness of the Enterprises, FHFA will provide sufficient advance notice before the effective date of any such changes.

UPFRONT FEE SCHEDULES

The Fannie Mae and Freddie Mac upfront fee schedules are available at the following URLs:

- https://www.fanniemae.com/content/pricing/llpa-matrix.pdf
- https://www.fanniemae.com/content/pricing/llpa-matrix-refi-plus.pdf
- http://www.freddiemac.com/singlefamily/pdf/ex19.pdf

[3] See footnote 2 for certain technical exceptions.

[4] There are a few exceptions to this cumulative add-on practice.