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September 8, 2014

Federal Housing Finance Agency
Office of Policy Analysis and Research
400 7th Street, SW, Ninth Floor
Washington, DC 20024

Re: Fannie Mae and Freddie Mac Guarantee Fees: Request for Input

Two Harbors Investment Corp. ("Two Harbors"), a real estate investment trust ("REIT") whose common stock is listed on the New York Stock Exchange under the symbol "TWO," welcomes the opportunity to submit this letter in response to the request of the Federal Housing Finance Agency ("FHFA") for comments concerning the various questions raised regarding guarantee fees ("g-fees") in the above-captioned request for input (the "Request"). Two Harbors appreciates the FHFA's attention to this topic and welcomes the FHFA's invitation to provide comments on all aspects of the Request. Our response letter is organized into two parts: Part I provides general comments regarding the topic and Part II provides responses to the specific questions posed in the Request.

I. General Comments

Two Harbors believes that the private label securities ("PLS") market for residential mortgage-backed securities ("RMBS") is an essential component of the U.S. mortgage market in order to provide the broadest availability of mortgage credit to creditworthy homebuyers at the lowest cost. While Two Harbors believes that addressing g-fees is an important factor to improve the competitiveness of the PLS market, it encourages the FHFA to be mindful of other factors impacting the development of the PLS market, such as the currently dominant role of Fannie Mae and Freddie Mac (the "Enterprises") in the RMBS market. Other securitized asset classes, such as auto loan, credit card, and commercial real estate securitizations, have largely returned since the crisis; a key reason for this is that these asset classes are not dominated by government participation at lower-than-market-rate pricing.

When assessing the current g-fee levels, Two Harbors urges the FHFA to consider the importance of reducing the Enterprises' footprint and, in turn, the risk to taxpayers should the housing market experience a downturn. Additionally, more appropriately setting g-fee levels can facilitate the return of private capital to support the U.S. mortgage market, potentially increasing the number of creditworthy borrowers who can access mortgage credit. Two Harbors believes that adjusting the g-fees to more accurately reflect the credit risk associated with a particular loan would be helpful in these endeavors. Because the PLS market has been largely non-existent since the financial crisis, investors have not had an opportunity to appropriately price the credit risk associated with many mortgage loans. This has, therefore, pre-empted the ability of the overall market to determine the appropriate charge for mortgage credit risk in large scale, as many market participants who might invest remain on the sidelines.

While it will take time to develop the PLS market, more appropriately realigning the g-fees for all types of loans is a key first step and will aid in this development, encourage existing and new market participants to commit time and resources to examining terms and costs, and eventually support the development of a robust channel for housing finance as an alternative to the Enterprises and government channels. This can provide a path to mortgage credit for borrowers who do not meet Enterprise or government criteria and reduce potential risk to taxpayers.

II. Responses to Specific Questions Posed in the Request

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

   Response: Two Harbors agrees that expected losses, unexpected losses, and general and administrative expenses are the appropriate economic factors to consider when setting g-fees. Two Harbors also recommends that the FHFA consider the following goals while setting g-fees: (a) reducing the Enterprises' currently dominant role in the RMBS market in order to reduce risk to taxpayers; and (b) facilitating the development of the PLS market in order to improve the liquidity, resilience, and sustainability of the entire mortgage market and mortgage credit access over time.

   To accomplish these goals, g-fees should be increased to allow for the development of a revived and sustainable PLS market that focuses on those loans that do not require government support to be extended at reasonable rates today.

   We also believe that loans that present higher risk should have appropriately higher g-fees so that U.S. taxpayers do not bear unnecessary credit risk. Current pricing of higher risk loans is much too low to compensate the Enterprises, and in turn taxpayers, for the risk they take on these loans. By increasing g-fees to accomplish these core objectives, it will reduce the competitive advantage that the Enterprises currently hold in the market, thereby increasing the likelihood of greater participation by private capital.

   In addition to considering the goals discussed above, we believe it is important for the FHFA to consider the volatility of potential losses when setting g-fees. For example, loans with certain riskier characteristics will have a greater distribution of probability of default and loss given default – they are likely to perform well in good economic and housing conditions and significantly underperform during stressful conditions. Level of down-payment is one such criteria. Variability in performance is important because loans with a higher variability of outcomes should have higher g-fees, while a loan with a lower variability should have lower g-fees.

   While appropriate for the government to set policy to specifically subsidize and support a particular market segment if policy decisions are made to do so, any support should be transparent and purposeful. If FHFA decides that it would like to support certain market segments or the housing market as a whole, it should be clear that by underpricing the private market, it is providing subsidy and selecting a policy, rather than risk management, path.

While we believe it was appropriate for the government to support pricing when the housing market was in free-fall and little mortgage credit was being extended outside of the government supported channels, it is less appropriate today when the market has recovered and the private market is both willing and able to take on this risk. If g-fees are set such that taxpayers continue to provide this outsized support, over time it will create market distortions and result in taxpayers absorbing losses should the housing market experience another downturn.

A countercyclical role for the government might be appropriate during economic and housing market stress, but if FHFA continues this outsized role during recovering and normal economic times, it is choosing a policy of continued economic support and could pull capital away from other, possibly more productive and efficient, uses. While private markets are not always perfect at pricing and allocating risk (e.g., during times of severe economic stress), it generally adequately prices risk and allocates capital across markets based on risk and return on capital considerations. Allowing the private market to enter and price this risk in large scale can help provide a market-based check to pricing determined by internal Enterprise models, government entities, and regulators.

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?**

Response: Two Harbors believes that g-fees should be adjusted to more accurately reflect the credit risk associated with a loan. Any other policy will almost certainly result in influencing the mix of loans that are delivered to the Enterprises in order to take advantage of any subsidized pricing. Specifically, the g-fees for the higher-risk loans should have increased g-fees to compensate for the increased credit risk inherent in these types of loans. If not, FHFA and the Enterprises will have to determine what specific loan characteristics the Enterprises need to maintain a diversified book and continuously re-price to make sure they are competitive in those areas – something that would likely be challenging, result in underpricing risk, and make it difficult for originators to set pricing consistently.

Realigning Enterprise g-fees using a risk-based pricing methodology would shift credit risk pricing closer to the levels that would help make sure that the GSEs are not adversely selected and help attract private capital to the mortgage markets. Setting g-fees to accurately reflect the credit risk of a loan would greatly reduce the Enterprises' current competitive advantage, which is crowding out the private sector and inducing risk to the Enterprises and, therefore, taxpayers. Until g-fees are adjusted to appropriately offset credit risk, it is unlikely that private capital will be attracted to the mortgage markets because the private capital providers are being priced out of the market for the higher-risk loans due to the underpricing of the risk by the Enterprises. By realigning the g-fees to accurately reflect the credit risk associated with a loan, it will generate investor demand in the PLS market.

Another alternative would be to regularly issue credit risk-sharing transactions to transfer Enterprise risk to private investors. The structure for these transactions should not be uniform across all risk-sharing pools, but instead should be tailored to account for the increased risk of certain pools as compared to others. Using risk-sharing transactions to offset the impact of credit risk would be helpful because it will reduce the U.S. taxpayer's exposure, while allowing private

market participants to play a role in pricing credit risk. Additionally, the amount of first loss risk sold should be similar to the amount of subordination required of the PLS market by the rating agencies. Otherwise, it would be unclear what the entire cost of this risk is to the Enterprises. This information could be useful to the Enterprises and GSEs to understand how the private market prices risk over time, indicate where the Enterprises could exit (and the PLS market could fill) and where the Enterprises might be necessary to ensure access to credit at rates that FHFA prefers. There has been growing investor demand for involvement in risk-sharing transactions because it is one of few opportunities for private investors to participate in the market.

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?**

   Response: Consistent with our response to Question #2, we believe that the capital requirements for the Enterprises should correlate with the associated credit risk of their portfolios to better protect taxpayers and improve the sustainability and resilience of the mortgage market. The capital standards and returns of participants in the PLS market, including banks, insurance companies, and REITs are informative on this topic because they monitor and adjust their capital as needed to account for the risk profile of their portfolios. The Enterprises should look to these types of institutions for guidance on the amount of capital and expected return, and then g-fees should be adjusted accordingly. Return expectations differ for different types of risk and in different market conditions and FHFA should look to private sector return thresholds and private sector ranges for economic capital when setting appropriate g-fees.

   Further, Two Harbors believes that the overall capital allocation of the Enterprises across risk buckets should reflect the size of the relevant market segment. Within each market segment, capital should be allocated based on the expected return and risk, similar to any private enterprise.

4. **At what g-fee level would private-label securities ("<u>PLS</u>") 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?**

   Response: As noted above, Two Harbors believes that increasing g-fees to reduce the competitive advantage that the Enterprises currently hold in the market would encourage bond investors that purchase the senior most securities (typically rated AAA) to give greater attention to the space. Over time, a sustainable PLS market will allow both a greater dissemination of credit risk (away from the government) and eventually enable securitization of loans to average quality creditworthy borrowers. This has two benefits: (i) diversifying risk and (ii) increasing access to credit as the private market is able to expand its offerings because it has readily available financing through securitization. This will help support a more sustainable housing finance system in the long run.

   Supporting a greater volume of loans to go through the PLS market in the near term will result in better liquidity and investor interest. This means that economic capital should be set at an equivalent standard that private market participants would calculate as necessary to absorb both expected losses and tail risk. Additionally, return on capital for loans should be set similarly to

the returns that private capital would deem necessary for that level of risk. This means that some loans would likely require much higher levels of economic capital than set out by FHFA's illustrative g-fee computation set forth in the Request. Other loans that are less risky could require less.

For loans held by higher-risk borrowers, the g-fees are currently too low and should be increased to accurately capture the associated risk, which would facilitate increased participation in the PLS market because the Enterprises' loan cost would be at a competitive level. By reducing the Enterprises' competitive advantage, it would ultimately drive supply towards the PLS market and spread risk more diversely among the participants.

Two Harbors believes that g-fees for the higher limit loans held by higher quality borrowers require little adjustment because the current rates for Prime Jumbo Loans are at, or below, the rates for Enterprise conforming loans. This fact illustrates that the breakeven g-fee rate is very close to current levels for higher balance loans held by higher quality borrowers. However, Two Harbors also believes that loan limits should be reduced because the private market is ready and willing to fund these higher balance mortgages. Our primary recommendation is, therefore, to lower loan limits. Absent FHFA's willingness to do that in the near term, FHFA could also consider increasing the g-fees for higher balance loans to test where the private market begins to compete. Our view is that a large number of loans currently being guaranteed by the Enterprises could be funded by the private sector at very little incremental cost and significantly reduced risk to taxpayers, and would help increase volume to restart the PLS market in large scale. Alternatively, a small loan limit decrease could significantly increase the volume of loans available to the PLS market even though it would only be a small portion of Enterprise business.

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?

Response: Two Harbors believes it is unlikely that higher g-fees will result in an overall decrease in originations for lower risk loans since private market rates are similar or lower than agency rates. Additionally, given large demand for the CAS and STACR programs, it is apparent that there is large demand from the private sector for the credit risk behind agency loans, particularly those of high quality. There appears to be a misconception that there is not enough private capital to support mortgage lending, but there is significant private capital ready and willing to take mortgage credit risk. There are entities with securitization platforms in place, ready to absorb more supply, including Two Harbors, but volumes have been too low to encourage investors to commit time and resources to this market. This is a very important step in expanding the PLS market share and reducing the GSE footprint.

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?**

   Response: Given that taxpayers are at risk for loans guaranteed by the Enterprises and insured by FHA, FHA should be encouraged to examine its g-fees at the same time to avoid a shift of the market to that channel. A shift to FHA is not desirable because U.S. taxpayers would still bear the risk of these loans. Both the Enterprises and FHA need to appropriately price the risk of these higher-risk loans, which would mean an increase in g-fees for the higher-risk loans. The importance of developing the PLS market should also be paramount in this discussion and simply shifting the destination of the loan from one entity that receives government support to another will not address the need for infusion of private capital to the U.S. mortgage market.

   The Enterprises and FHA should coordinate to align their g-fees with the associated credit risk of these higher-risk loans, which will open the door for private market participants because the environment will foster competition. It will also help reduce risk to taxpayers, rather than simply shifting it from one form of taxpayer risk to another.

   The PLS market is likely better positioned to price these higher-risk loans than the Enterprises or FHA, and it is certainly more advantageous to U.S. taxpayers should there be another housing downturn for the PLS market to absorb this risk. The goal of increasing g-fees for these higher-risk loans should be to diminish the current competitive advantage that the Enterprises have over private market participants, which would not be accomplished if the loans are simply shifted to FHA.

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?**

   Response: Charging higher g-fees on high credit score/low LTV loans would help shift incremental risk away from taxpayers, particularly since the private market has shown an ability and willingness to finance these loans. This would help reduce taxpayer liability while still maintaining a functioning housing finance market. Additional loan volume will also likely help restart private label securitization, which will further help reduce taxpayer risk overtime as this channel grows. It will also encourage the private market to build the infrastructure necessary to accommodate higher volumes of PLS, including the ability to expand into low credit score/higher LTV loans.

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

   Response: Two Harbors believes that the FHFA should continue to support loans to low to moderate-income borrowers, while at the same time facilitating the development of the PLS market.

   Two Harbors believes that the Enterprises should use risk-based pricing to determine the appropriate g-fees for loans made to low- and moderate-income borrowers. Although this may

result in higher fees than for other lower-risk loan types, as discussed above, this is necessary unless the Enterprises are prepared to be adversely selected.

One way to offset a potential increased cost to the borrowers would be to provide government-sponsored rebates paid by the Enterprises to borrowers, which will allow the Enterprises to then reduce the cost to this sector of borrowers. The rebates would allow the pricing of credit risk to be transparent, but also allow the Enterprises to fulfill their mission to maintain broad access to credit, even if lower returns must be accepted. The amount of the rebates could be determined by considering relative pricing to purely private channels and acceptable cost impact to low- and moderate- income borrowers. FHFA could also consider the risk these loans pose to the Enterprises and the amount of loans to low- and moderate-income borrowers held by the Enterprises as compared to their overall portfolio holdings to determine levels of rebates.

This approach will serve the following purposes: (a) establish the appropriate capital charge and g-fee for this type of loan without any consideration to the achievement of any policy goals; and (b) the government-sponsored rebate will aim to achieve policy goals without compromising transparency about the "true cost" of insuring these loans. Using this approach, the Enterprises and FHFA can be clear overtime exactly where subsidy is being provided for policy reasons and differentiate that from where credit risk might be underestimated. This suggestion may be the optimal approach because it serves the dual purpose of aligning the Enterprise's expected returns on this loan type with other loan types while at the same time accomplishing important policy goals.

FHFA could also consider selling "vertical" pari passu credit securities, similar to the CAS and STACR programs, except that the buyer would take a vertical rather than first loss risk exposure. This could help FHFA and the Enterprises determine where the private market would price credit risk in order to better understand the amount of subsidy being provided.

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?

Response: Two Harbors believes that the current ranges of credit scores are appropriate, allowing for adequate granularity to appropriately risk-based price. If the Enterprises use buckets that are broader than private sector pricing grids, there is a risk that the Enterprises will be adversely selected within those broader buckets, so that the only receive the more risky loans in any particular bucket.

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

Response: Two Harbors believes that the risk-based pricing should be uniform across the Enterprises to ensure consistency. Since loans present the same credit risk and ultimately risk to the taxpayer no matter which Enterprise they are guaranteed by, it does not make sense to have different pricing, and could result in distortive competitive pricing if the GSEs try to compete with each other to gain market share.

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?**

    Response: Two Harbors believes that state-level adjustments are likely appropriate for states where there is a lengthy foreclosure timeline, high foreclosure costs and unresolved inventory.

    In order to better incorporate regional home price changes, the FHFA should consider implementing a methodology similar to that used by rating agencies to incorporate the pace of home price changes into credit pricing, which would allow the Enterprises to alter pricing to appropriately respond to changing market conditions relatively quickly.

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

    Response: Because Enterprise loans are classified as Qualified Mortgages (QMs) while in conservatorship or for seven years, regardless of whether such loans meet the CFPB's debt-to-income criteria), any changes in g-fees will impact the cost of credit for Qualified Mortgage lending, which will eventually be reflected in non-Qualified Mortgage lending, as well. As the government works towards housing reform and reducing the Enterprises' footprint, the FHFA should also consider the impact of g-fees after the Enterprises' loan programs no longer classify as Qualified Mortgages. After this is no longer the case, then g-fees may have to be adjusted to account for the increased risk of these loans no longer being automatically classified as Qualified Mortgages.

We appreciate the opportunity to provide the foregoing comments in response to the Request and would be pleased to participate in further discussions with the FHFA on this topic. Please do not hesitate to contact me via telephone at (612) 629-2500 or via email at thomas.siering@twoharborsinvestment.com if you have any questions or desire clarification concerning the matters addressed in this letter.

Sincerely,

Thomas E. Siering
President and Chief Executive Officer