Kevin P. Watters
Chief Executive Officer
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September 8, 2014

SUBMITTED ELECTRONICALLY

Mr. Joseph Prendergast
Manager of Policy Research
Federal Housing Finance Agency
Office of Policy Analysis and Research
400 7th St., SW, Ninth Floor
Washington, DC 20024

Re: FHFA's Request for Input on Fannie Mae and Freddie Mac Guarantee Fees

Dear Mr. Prendergast:

JPMorgan Chase & Co. ("Chase") welcomes this opportunity to respond to the request for input referenced above (the "RFI"). Chase applauds the Federal Housing Finance Agency ("FHFA") for seeking input regarding the determination of the guarantee fees ("G-fees") that Fannie Mae and Freddie Mac (collectively, the "GSEs") charge for guaranteeing the timely payment of principal and interest on the mortgage-backed securities they issue. We are pleased that FHFA recognizes the importance of advancing the dialogue and transparency regarding the framework for properly setting the GSEs' G-fees.

As of Q2 2014, Chase ranked second in both origination volume (7.2%) and servicing volume (9.9%) for residential mortgages in the United States[1]. We were also the second largest seller to both Fannie Mae and Freddie Mac in Q2 2014. Given Chase's commitment to the mortgage market and the consumers it serves, we are deeply interested in the GSEs' financial health and stability.

This letter is structured to provide Chase's perspective about the importance of preserving a framework that sets G-fees at the loan level, and identifies some of the variables that can markedly influence the GSEs' ability to support the U.S. mortgage market through economic cycles. Chase supports a thorough review of the GSEs' G-fee framework and a robust discussion about the impact that GSE G-fees can have in the broad U.S. mortgage market. This letter cannot, however, address all relevant issues impacting the structure of the U.S. mortgage market, as there are many moving parts to consider.

Chase recognizes that G-fee decisions are complex and need to balance many competing priorities. Consistent with Director Watt's speech on May 13, 2014 in which he noted the FHFA will focus on "how best to fulfill (the FHFA's) current obligations under current law," Chase evaluated the RFI based on the current state of the GSEs, not their past or their potentially reformed future. Accordingly, this letter

[1] Source: Inside Mortgage Finance

reflects both the constraints of the Conservatorship and the relationship with the U.S. Treasury under the Senior Preferred Stock Purchase Agreement ("PSPA").

Director Watt also has noted that the FHFA should be concerned with the GSEs' safe and sound operation, preserving and conserving their assets and ensuring a liquid and efficient national mortgage market. Accordingly, the optimal framework to achieve these objectives should be based on prudent capital standards and returns, coupled with rigorous risk-based pricing that encourages private capital participation to the fullest extent possible to best serve the consumers, taxpayers and the broader mortgage market. The ultimate goal of the GSEs' capital framework should be more than simply providing adequate loss absorption capacity. It should also ensure the GSEs remain capable of operating under a stressed environment for a prolonged period of time while properly insulating U.S. taxpayers from having to provide extraordinary support once again.

Addressing current regulatory, legal and contractual uncertainty, particularly with respect to the GSEs' representation and warranties framework, including servicing issues, is an essential element to ensuring that G-fees are commercially reasonable. Disregarding the need to address such uncertainty adversely impacts mortgage affordability by encouraging the GSEs to under-price credit risk as they are able to seek remedies not contemplated by contract to offset any G-fee mispricing. Such uncertainty dampens lenders' willingness to fully utilize the available credit box lest they be called upon to become indemnifying parties in what should be ordinary commercial disputes with the GSEs. Enhancing regulatory, legal and contractual predictability will improve mortgage affordability and could act as a balance to offset any increases in G-fees without compromising capital and risk based pricing integrity.

G-fees Should Reflect the GSEs' Systemic Significance and Be Based on Rigorous Standards

Fannie Mae and Freddie Mac, in their current form, are systemically significant[2], and they should be treated accordingly. G-fees and capital[3] should be set at a level that recognizes this fact. Chase believes that the appropriate level of capital and G-fee pricing to support the GSEs' mortgage guarantee business should be judged in light of the recent financial crisis, as well as their continued volume of business and market concentration. Capitalizing the GSEs more leanly than the inherent risks of their businesses and their systemically significant characteristics imply would undermine the GSEs' future ability to provide unassisted countercyclical support to the U.S. mortgage market in the event of a future housing downturn. Moreover, mispricing G-fees would undermine efforts to restore the role and share of private capital in the U.S. housing market, perpetuating the GSEs' outsized footprint in the U.S. housing market.

FHFA should be commended for highlighting the need to correctly price GSE G-fees through a transparent and disciplined model that explicitly shows relevant pricing model components. G-fees also should provide for a return that adequately compensates the GSEs and the taxpayers for the risks they undertake. However, in pricing to achieve those returns, GSE G-fees should fully and transparently reflect loan level credit risks. Correctly assessing mortgage credit risk is vital to calculating the

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[2] After being placed in Conservatorship by the FHFA, the U.S. Treasury took extraordinary measures, including the U.S. committing nearly $447.5 billion and injecting $189.4 billion to buttress the GSEs' capital and enable their continued market operations.

[3] Reference to "reserves" rather than "capital" could arguably be more appropriate given the inability of the GSEs to build and retain capital under the terms of the PSPA. We use "capital" in this letter; however, as it is the construct used in the RFI and historically used by the GSEs. Regardless of accounting and terminology, there is a need for a buffer that can provide loss absorption and support the GSEs' continued mission under times of stress without assistance from the U.S. government.

appropriate level of G-fees and reserves to support the GSEs' operations. G-fees should be based on empirical, transparent and replicable credit-loss data. Doing otherwise will introduce pricing distortions that could hinder the pace of private capital return, invite risky behaviors like those seen before the last market downturn, risk over-exposure to or inflation in segments of the housing market, and destabilize the GSEs, thereby putting taxpayers at further risk during times of stress.

The framework illustrated in Figure 2 of the RFI provides a reasonable starting point to assess G-fees. The three most critical elements are the appropriate **assumed capital requirement for the GSEs, the rate of return that should be targeted on that capital and finally the pricing mechanism to achieve those returns**. These elements are addressed in the discussion below.

Appropriate Capitalization

Determining the right amount of capital that the GSEs should assume today in their determination of G-fees is not readily apparent given the current state of and legal constraints that apply to the GSEs, including the PSPA, which effectively disallows for the accumulation of capital. It is clear from page 3 of the RFI that the FHFA appreciates this challenge and is focused not on whether the GSEs have adequately capitalized their existing book of business and waning balance sheets, but rather ensuring there is a method in place to ensure incremental business is appropriately capitalized and priced (notwithstanding the GSEs' inability to retain and account for that capital on their balance sheets). For these reasons, an asset based approach to capitalization and pricing can and should be implemented to achieve this goal.

A review of both historical experience and the regulatory regimes applied to other systemically significant institutions provides helpful benchmarks to inform the analysis. This evaluation points to an approach similar to the Basel III Advanced Approach as the most suitable model to assess incremental assets guaranteed by the GSEs for capital adequacy in their current state. This approach is a familiar methodology in the financial and regulatory community. Following a Basel III approach allows for a transparent, generally replicable and tailored assessment that dynamically adjusts to reflect changes in the GSEs' evolving book of business, macro economic conditions, and home price fluctuations.

Pre-conservatorship and 'comparables':

It is valuable to start the analysis by recalling, as a baseline, the capital standards in effect at the time of the conservatorships. Such standards required capital levels that proved insufficient to absorb losses experienced and required the FHFA to place the GSEs in conservatorship, followed closely by extraordinary financial assistance from the U.S. government and taxpayers. Prior to conservatorship, the GSEs were held to a static statutory requirement. Core capital[4] was required to equal at least 2.50% of on-balance sheet assets and 0.45% of off-balance sheet assets. The GSEs also were held to additional risk-based requirements calculated on "total capital"[5].

Under pre-crisis capital standards, the GSEs were required to simulate their financial performance over a ten-year period of severe economic conditions characterized by both extreme interest rate movements and high mortgage default rates. Simulation results indicated the amount of capital required to survive

[4] Core capital was defined as the sum of the stated value of outstanding common stock (common stock less treasury stock), the stated value of outstanding non-cumulative perpetual preferred stock, paid-in capital and retained earnings, as determined in accordance with GAAP.

[5] Total capital was defined as the sum of our core capital plus the total allowance for loan losses and reserve for guaranty losses in connection with guaranteed MBS, less the specific loss allowance (that is, the allowance required on individually-impaired loans).

this prolonged period of economic stress **without new business or active risk management action**. In addition to this model-based amount, the risk-based capital requirement included a 30% surcharge to cover unspecified management and operations risks. While the result of these risk-based requirements ultimately understated the capital needed both to provide an adequate loss absorption buffer and to enable the continued operation of the GSEs through the last downturn, the approach has sound underpinnings that inform this comment letter.

Comparables are challenging to identify:

A "comparables-based approach" was considered, including reviewing other concentrated, monoline insurers as well as the Federal Home Loan Banks given their GSE status and comparable mission. Ultimately, it is unavoidable to conclude that Fannie Mae and Freddie Mac are truly incomparable entities.

Not only are the GSEs unique in their core business and structure, operating in conservatorship, but also in their presence and significance to their core market and the U.S. economy today. The GSEs are rather unique in their systemic interconnectedness and relevance wherein their uninterrupted operation actually defines and enables the continued operation of the market where they exist. Nothing proves this point more than the conservatorship state today which resulted from a determination that any impairment to a credible TBA, or the GSEs' ability to service their outstanding debt or guarantee their mortgage related obligations, would have been and could be systemically destabilizing.

Historical losses provide a reference point, but not sufficient:

Another approach considered was whether a methodology reliant upon historical loss rates through the last period of financial stress would be sufficient to determine a minimum capital threshold going forward. However, based on the recent experience, it should be clear that any potential future crisis could (and likely would) be unprecedented as well. Although holding sufficient capital to survive the losses experienced based on the composition of the books of business the GSEs held during the most recent turmoil could prove sufficient to absorb losses in future stress environments and allow the GSEs to continue to operate, this approach is *not* designed to be dynamic and does *not* reflect the evolving nature of the GSEs business and the unpredictable global economic forces influencing today's mortgage and capital markets on which the GSEs must rely to distribute credit risk.

A method similar to the Basel III Advanced Approach holds promise:

Today, the Basel III Advanced Approach is a widely recognized, global framework utilized by large banks to determine the appropriate capital levels for assets with varying degrees of risk. By adopting such a method that relies on loan-level, risk-based capital modeling, a determination could be made about the capital required to absorb unexpected losses resulting from a range of forecasted stressed environments with a 99.9% statistical confidence interval. Since the approach is dynamic, it would allow for capital levels to flex with the evolving composition of the GSEs' book of business, housing market conditions, as well as the FHFA's risk tolerance for losses through adjustments to the confidence interval.

G-fees should be determined at levels necessary to generate the capital demanded plus required returns. Using such a dynamic capital assessment process would be well suited to strike the necessary balance among the competing needs to safeguard the GSEs from expected losses, provide reasonable unforeseen loss absorption capacity, and maintain credit affordability and availability. It is important to adapt the modeling to reflect the GSEs' importance to the U.S. housing market, by adopting an

appropriate time horizon and severity of stress for the assets being assessed such that there is confidence that adequate capital exists to sustain a nationwide financial crisis or economic downturn that may well last longer than the current distressed period. Therefore, it is critical that that FHFA survey strong banks that take on similar exposures to inform segmentation, stress scenarios, time horizons and other material factors to inform the GSEs' models. Further, given the importance of the GSEs and the length and depth of this last downturn, the GSEs also should be required to take an approach that assumes a significant and prolonged stress environment when stressing its models.[6]

FHFA should consider a capital surcharge:

As was noted above, during the pre-conservatorship period, OFHEO incorporated a 30% surcharge to risk-based capital results to insulate against management and operational risks. Under the Basel III framework, large, internationally active banks are subject to surcharges beyond the 8% minimum total capital requirement. These include a capital conservation buffer, countercyclicality buffer and a surcharge for globally systemically important financial institutions.

Similarly, it would be advisable, and consistent with market practice, to add a surcharge to modeled capital levels that is significant enough to account for the concentration and cyclicality of the GSEs' business and, importantly, for the systemically significant nature of the GSEs. These surcharges should be designed to enable the GSEs to continue to operate through a prolonged period of market stress.

Accordingly, the Basel III Advanced Approach model offers the best mechanism to determine capital given the GSEs' unique complexion. Capitalizing the GSEs at levels below what is analytically and transparently supportable would put U.S. taxpayers at risk, and undermine global investors' confidence and the GSE's future ability to provide countercyclical support to the U.S. mortgage market during or after a severe financial crisis. Moreover, it would inhibit efforts to restore the important role of private capital in the U.S. housing market and do nothing to mitigate the GSEs current concentration and outsized footprint in the U.S. housing market, thereby increasing the U.S. taxpayers' exposure to a future economic downturn.

Targeted Rate of Return

The rate of return that the GSEs target is one of the most sensitive drivers of G-fees in this proposed framework. Accordingly, a thoughtful assessment of the appropriate rate of return target is critical. At a minimum, the GSEs should target a rate of return that at least covers their cost of capital. However, determining the GSEs' cost of capital is not readily apparent given their unique state of conservatorship and their limited and defined pool of available capital in the form of the $447.5bn committed under the PSPA as amended with the Treasury, $189.4bn of which has been drawn. Some might rationalize that the GSEs implied cost of equity is equivalent to long term Treasury rates given that the senior preferred is provided by Treasury and funded through the Treasury market. However, this view is flawed for several reasons. To begin, that view would imply a cost of equity that is lower than their observable, arguably distorted, cost of debt -- which would be anomalous. But, more importantly, there are both observable benchmarks and sounder reasoning that lead us to believe that the required rate of return should be materially higher.

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[6] Given the interconnectedness of the housing finance and banking systems, it may be helpful for the FHFA to align its loss absorption and stress methodologies with guidance from the regulatory agencies that oversee the application of the Basel III Advanced Approach.

Market equity returns:

Since the goal of the FHFA and the proposed model is to determine G-fees by adequately capitalizing risk and to determine a reasonable, risk-adjusted rate of return on those assets, it is fitting to consider the expected return on a broad diversified market, such as the S&P 500, as a reasonable initial return benchmark. The 12 month forward total return expectation for the S&P 500 amounts to 9.4%[7]. This is a useful proxy to start with, but the S&P 500 is not an optimal measure for GSE returns because the taxpayers' investment in the GSEs suffers from both illiquidity and uncertainty about if and when capital will be returned. Additionally, the business of the GSEs is highly concentrated, volatile, and cyclical. Therefore, it may be appropriate to adjust average total return expectations up from here to compensate for these material market risk differences.

PSPA's 10-12% return as a floor:

Before the dividend structure under the Preferred Stock Purchase Agreements was altered through the third amendment to effectively require a sweep of any profits to the Treasury, the senior preferred carried a 10% dividend which could be as high as 12% if a given GSE did not pay all in cash. Additionally, the PSPA originally contemplated that beginning on March 31, 2010, the Treasury was entitled to receive a commitment fee as compensation for the explicit support provided by the PSPA. Notably, these terms were set by Treasury thoughtfully and attempted to reflect the extraordinary nature of the U.S. government's assistance. At minimum, therefore, 10-12% should remain the absolute floor in considering an appropriate rate of return.

Mortgage Insurer returns:

While certainly imperfect comparables, mortgage insurance companies that are majority focused on the single family mortgage market could inform a decision. These institutions stand ahead of the GSEs in taking losses for the limited portion of any given loan for which they provide credit guarantees. The sector today, however, is composed of a small number of firms and has gone through a great deal of change with newly capitalized entrants with growing books of business as well as longer standing entities still working their way out of legacy exposures. Accordingly, the appropriate return target analysis should review the return expectations on mortgage insurers both on a forward-looking basis as well as during the late 1990's before the most recent significant market disruption and the subsequent reconstitution of the sector. An analysis of these firms leads us to believe that an after-tax return expectation in the mid-to-high teens is quite reasonable.[8]

Other considerations:

A final consideration in determining the targeted rate of return is the degree to which the FHFA aims to encourage private capital to enter the market and reduce the dominant market share the GSEs currently control. This consideration is critical to diversifying the sources of capital supporting the mortgage market, mitigating taxpayer risk and best serving consumers by facilitating pricing efficiency. The closer the FHFA sets the rate of return to or beyond the required returns of private sector entities competing

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[7] Source: Bloomberg consensus estimate

[8] Mark Zandi, in his paper entitled 'Cost of Housing Finance Reform' dated November 2013, suggested a pre-tax rate of return of 20% as reasonable based on financial institutions with 'similar risk profiles' as well as what private mortgage insurance company generally target.

in the mortgage market, the more incentive will be provided to and the faster private capital will be able to return to the market.

Taking into consideration all of the analyses laid out above, it is clear that a return hurdle in the **mid-teens** is reasonable for the FHFA and the GSEs to target, both to compensate for the potential cost of capital were the GSEs private sector entities *and* to compensate taxpayers for their extraordinary and illiquid investment in the GSEs.

Risk Based Pricing

The final element of the framework is pricing. Our proposed framework recommends that FHFA and the GSEs determine capital on an asset-by-asset basis as reflected by the risk underlying each asset. With the capital level and a return hurdle established, pricing should be readily determinable. Significantly, the GSEs should adhere to loan-level, risk-based pricing that is both transparent and replicable. This approach will allow for any cross subsidization within the GSEs books of business to be readily observable and ideally, minimized. A G-fee framework that mis-calibrates loan level credit risk or favors cross-subsidizing lower credits at a "portfolio level" is ineffective, risks encouraging over investment in housing, overexposes taxpayers to the mortgage market and could jeopardize the GSEs' ability to generate adequate capital to protect them and the American public during times of stress.

We do not aim to propose a view in this paper on how the proportion of that risk based price should be split between ongoing G-fees as opposed to one-time, upfront loan level price adjustments ("LLPAs"). However, operational simplicity and customer impact should be important considerations in this determination. Finally, transparency should be a priority. To the extent the FHFA feels compelled to subsidize market segments in any way, that should materialize in pricing rather than inadequate capital standards or adjusted return hurdles. Transparent pricing that shows certain risk segments priced high to allow for other risks to be priced lower while still meeting capital requirement and overall return hurdles will allow for both accountability as well as information for the private market to quickly react and adapt accordingly.

Putting It All Together

Below we have adapted an example in similar form to Figure 2 in the RFI to illustrate how this framework can be used to determine an appropriately priced G-fee. Exhibit 1 below displays the build up for one loan or security composed of similar assets that generally reflect 0-60% LTV and FICOs in the 740+ segment. After incorporating a 1% capital assessment based on a simplified Basel III Advanced Approach for indicative purposes, a 15% after-tax return hurdle and accounting for expenses including expected losses, general and administrative expenses and the 10bp payroll tax surcharge (TCCA), an implied G-fee of 42bps is the result.

Exhibit 1:

Illustrative G-fee calculation		
Capital and return requirement assumptions		
	LTV / FICO	0-60 / 740+
A	Capital required (bps)	100
B	Required after-tax return	15.0%
G-Fee components (bps)		
C=(1/.65)*A*B	G-fee to meet return hurdle	23
D	Expected losses	2
E	G&A expenses	7
F=C+D+E	**Subtotal of estimated costs**	**32**
G	TCCA 10 bp increase	10
H=F+G	**G-fee implied**	**42**

Exhibit 2 illustrates how the framework can be used to dynamically set capital and adjust G-fees across a range of risk buckets.

Exhibit 2:

Capital

LTV	FICO 740+	FICO 701-740	FICO 640-700
0-60	1.00%	1.25%	1.75%
61-70	1.50%	2.00%	2.75%
71-80	2.50%	3.00%	4.00%
81-90	3.75%	4.25%	5.75%
91+	5.00%	5.25%	6.25%

Annual Losses

LTV	FICO 740+	FICO 701-740	FICO 640-700
0-60	0.02%	0.03%	0.07%
61-70	0.04%	0.09%	0.16%
71-80	0.06%	0.14%	0.25%
81-90	0.09%	0.20%	0.38%
91+	0.12%	0.26%	0.49%

Implied G-fees (bps)

LTV	FICO 740+	FICO 701-740	FICO 640-700
0-60	42	49	64
61-70	56	72	97
71-80	81	100	135
81-90	112	135	188
91+	145	164	210

It is instructive to evaluate how the results of this approach, if in use today, would compare to G-fee pricing in effect. In the illustration below, we estimated actual G-fees charged today by taking annual average fees and adding LLPAs, converted to an annual equivalent, by FICO and LTV. The results imply that for the highest credit, lowest LTV loans, G-fees are close to where they should be to provide appropriate capital to support the risk and deliver a 15% after-tax ROE. However, for higher LTV, lower credit loans, G-fees appear to be inefficiently priced.

Actual G-fees (bps)

LTV	FICO 740+	FICO 701-740	FICO 640-700
0-60	45	45	53
61-70	50	55	66
71-80	53	63	92
81-90	55	65	91
91+	55	65	88

Actual - Implied (bps)

LTV	FICO 740+	FICO 701-740	FICO 640-700
0-60	3	(4)	(12)
61-70	(6)	(17)	(30)
71-80	(28)	(38)	(43)
81-90	(57)	(70)	(97)
91+	(90)	(99)	(123)

Now, this illustration is simplified and relies on a number of assumptions, including the indicative capital models we used for this example. Nonetheless, these results are likely conservative. For example, our illustration does not provide for any capital surcharges as we suggested earlier. Additionally, the FHFA

might choose to assume, and we would support, stress scenarios that are even more conservative than our own and/or inclusive of longer stressed time horizons.[9]

Question-by-Question Responses

Based on this approach, analysis and the results set forth above we have addressed the 12 individual questions posed in the RFI in Attachment 1 to this letter. Our answers are addressed in bullet form to facilitate aligning them with the themes raised in this comment letter.

Conclusion

The GSEs' current systemic significance to the U.S. mortgage market and global finance system requires careful calibration of G-fees if the GSEs are intended to provide stable, unassisted, countercyclical support to the U.S. housing market until such time as a legislative solution is determined.

Under these parameters today, GSE G-fees should be priced to fully reflect loan level risk and capital necessary to weather significant market shocks while providing a reasonable return to the taxpayers who have provided extraordinary support. Further, a Basel III Advanced Approach framework offers the best mechanism to determine capital given the GSEs' uniqueness, systemic significance and need to adequately capitalize and price credit risk on a granular and forward looking basis. Setting capital standards and pricing in a way that is not analytically supportable and transparent would put U.S. taxpayers at risk, and undermine global investors' confidence and the GSEs' future ability to provide countercyclical support to the U.S. mortgage market during or after another period of financial or economic stress, and would impede a timely transition to a future, reformed state for the U.S. mortgage market.

Chase appreciates the opportunity to engage in this dialogue that the FHFA initiated. We look forward to working productively with the FHFA and the GSEs to support our shared interests.

Sincerely,

Kevin P. Watters
CEO, Chase Mortgage Banking

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[9] The current downturn is in its 6th or 7th year depending on whether one considers its starting point to be 2007 or 2008. Aside from that detail, the expectation of a protracted crisis appears more than reasonable based on recent experience.

Attachment 1

J.P. Morgan Chase
Answers to Questions in the FHFA's
Request for Input on Fannie Mae and Freddie Mac Guarantee Fees

These answers supplement, and should be read in conjunction with, the comment letter filed by JPMorgan Chase & Co. on September 8, 2014 relating to the to the FHFA's Request for Input on Fannie Mae and Freddie Mac Guarantee Fees (the "Chase Comment Letter")

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?**

Answer

- FHFA and the GSEs should set G-fees using clear and transparent models that fully reflect loan level risks, general and administrative expenses, a reasonable rate of return and buffers to account for risks that cannot be properly captured in models. We agree with the FHFA's statement that the GSEs should "estimate g-fee levels consistent with the amount of equity capital they would need to support this business if they were financially healthy and retained capital."[1] Expected losses, unexpected losses, and general and administrative expenses are fundamental inputs for an appropriate capitalization and risk based pricing framework. As discussed in more depth in the Chase Comment Letter, the GSEs should undertake an asset-based approach similar to the Basel III Advanced Approach, providing for unexpected losses and reasonable buffers, when determining the capital that should be assumed in setting the G-fee on each mortgage guaranteed. Employing such a framework is consistent with our shared goal of ensuring the GSEs' ability to protect U.S. tax payers from future mortgage losses and providing uninterrupted support to the mortgage markets during a prolonged period of market stress.

[1] See page 3 of the RFI

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?**

   Answer

   - We do not believe that alternatives to risk based pricing are beneficial to the GSEs or the market at large. If the GSEs properly price for risk, the risk to the GSEs should not materially increase even if the proportion of higher-risk loans guaranteed by the GSEs increases relative to the proportion of lower-risk loans. The GSEs' mission to provide liquidity to the mortgage market is not inconsistent with, and should not result in a crowding out of private capital seeking to invest in or retain lower-risk loans.

   - Moreover, the GSEs fulfill their mission when providing liquidity to mortgage loans that may not otherwise be attractive to private investors. Mispricing credit risk undermines the GSE's mission of providing continued safe and sound operations through market cycles, particularly periods of market stress. Mispricing credit risk misallocates resources by promoting overinvestment in housing, promoting asset bubbles and increasing the chances that U.S. taxpayers will need to bear the risk of supporting the GSEs operations through a future downturn.

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?**

   Answer

   - The Chase Comment Letter describes important considerations for determining an appropriate loan-level G-fee reflecting loan-level capital allocation, appropriate return hurdles and risk-based pricing.

   - Furthermore, in setting appropriate capital requirements, the FHFA should consider applying a capital buffer or surcharge to the results of a Basel III Advanced Approach calculation to more properly reflect the nature of the GSEs' business and their global systemic importance today. To illustrate how one might apply a capital buffer given the unique status and legal structure of the GSEs in conservatorship, we provide an example below for illustrative purposes.

   - The example below leverages the assumptions and results underlying Exhibits 1 and 2 in the Chase Comment Letter. Within the Basel III framework, the G-SIFI buffers range from 1.0 – 2.5%. Assuming a Basel III total capital requirement of 10.5%, a 2% surcharge equates roughly to a 20% capital surcharge. Were this the requirement, the GSEs could calculate a given loan's risk under the

Advanced Approach, as illustrated in Exhibit 1 of the Chase Comment Letter, and gross-up that result by 20%. The example below shows the incremental G-fee impact, in bps, of a 2% surcharge to the 'Implied G-fee' box in Exhibit 2 of the Chase Comment Letter.

Incremental G-fee impact at 20%				
		FICO		
		740+	701-740	640-700
LTV	0-60	5	6	8
	61-70	7	9	13
	71-80	12	14	18
	81-90	17	20	27
	91+	23	24	29

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?

Answer

- Waiting for private investors to return to the US housing market should not be a condition precedent to the GSEs accurately pricing mortgage risk and setting G-fees correctly. FHFA and the GSEs can play an important role in restoring market balance by pricing mortgage risk properly rather than subsidizing gaps that the private market may yet be unwilling to fill.

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?

Answer

- Given that G-fees are one of many important factors that can explain loan origination volumes, it is very difficult to answer this question with certainty. Since a key objective of the FHFA and the GSEs is to ensure the availability of affordable credit in a manner that is safe and sound for all mortgage credit market participants, it is overly narrow to focus on G-fees alone as the lever to achieve the broader goal of increasing mortgage originations. We believe that the framework proposed in the Chase Comment Letter will help promote discipline, safety, consistency, transparency and balance across the entire mortgage market.

    - ➢ For example, prolonged regulatory, legal and contractual uncertainty, particularly on the servicing side of the mortgage business has begun to manifest in increased pricing. Focusing on addressing and mitigating these systemic issues will result in greater affordability and could act

as a balance to offset any increases in G-fees without compromising capital and risk based pricing integrity.

- Additionally, rate sensitivity in the market appears to be very low at this time. This makes it a good time in the overall market cycle to implement disciplined changes without risking materially adverse impacts. We anticipate the impacts of rate increases will be felt most by borrowers that likely would qualify for, and may be better served by, government programs such as FHA, VA and USDA.

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?

Answer

- A disciplined risk-based pricing framework at the GSEs may result in certain loans being insured by and securitized through FHA and other U.S. Government guarantee programs rather than through the GSEs. This should not be discouraged. Risk-based credit pricing works best when it directs borrowers to appropriate sources of credit, particularly the sources best positioned to serve their credit needs. As more fully discussed in the Chase Comment Letter, capital, ROE and risk based pricing discipline, should drive the allocation of capital at the GSEs.

- The GSEs should not cross-subsidize mortgage loans, but focus on offering the best price to all conforming borrowers based on borrower and loan characteristics. The pursuit of social policy goals through cross-subsidization and other non-market-based techniques should reside within the guarantee programs administered by the US Government, such as FHA, VA, USDA, PIH, etc.

- To the extent any cross subsidization does occur within the GSEs books of business, it should be made transparent to the market and show up in pricing sheets as discounts or markups to the risk-based pricing results.

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?

Answer

- Risk-based credit pricing works best when it directs borrowers to appropriate sources of credit, particularly the sources best positioned to serve their credit needs. It would be inappropriate for the GSEs to intentionally mis-price conforming balance loans with high credit scores and low LTVs

simply to redirect these loans to private market investors. This would undermine the safety, soundness and systemic resiliency of the GSEs.

- Sound risk-based pricing facilitates best execution and helps optimize the allocation of housing credit among public and private sources of capital, reflective of risk, utility, and if applicable, social policy. Pricing mortgage risk correctly allows for better diversification of the sources of funds directed to the housing market and places credit risk among investors better positioned to bear and withstand those risks. Directing borrowers to appropriate sources of credit and diversifying the sources of capital supporting the U.S. mortgage market will help increase the resiliency of the U.S. housing finance system to handle market stresses.

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?**

Answer

- HERA's mission requirements should not be accomplished at the expense of the GSEs' safety, soundness and systemic resiliency. We believe that a risk-based framework as described in the Chase Comment Letter, which will enhance transparency, stability and confidence in the safety and soundness of the GSEs will promote greater liquidity and investor participation in the broad mortgage market. We also believe adopting a risk-based framework is consistent with the restoration of sound practices and the financial health of the GSEs, which should facilitate resolution of the conservatorships and the transition to a reformed future state.

- Additionally, we do not believe that the framework described in the Chase Comment Letter would prevent the GSEs from developing new products or relationships to promote low- and moderate-income housing credit nor from fulfilling their other requirements to serve underserved markets.

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?**

Answer

- Risk-based pricing is the best alternative to ensure that the GSEs operate in a safe, sound and resilient manner. Risk-based pricing models could be refined if greater loan level pricing precision is desired. For instance factors could be expanded to account for geographic concentrations or risk associated with jurisdictions with expanded servicing obligations, challenging foreclosure timelines or elevated eminent domain risk. However, risk based pricing granularity should be measured to

avoid unreasonably complicating the operating environment for mortgage originators and sellers or adversely impacting the TBA market.

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

Answer

- If the FHFA were to adopt and require the GSEs to utilize the framework described in the Chase Comment Letter, then there would not likely be material deviation in pricing for a given loan between the GSEs. However, it is conceivable that to the extent that one GSE can operate materially more efficiently than the other, then less margin would be required to achieve the same return on the same amount of capital, thereby justifying a potential difference in G-fee pricing. Additionally, to the extent that capital modeling is not completely harmonized, capital charge differences could exists for the same loan that could result in differences in G-fee pricing.

- If it is desirable to allow some competition between the GSEs, it is critical, to ensure that both GSEs operate safely and soundly to avoid market concentration and potential systemic dislocations arising from only one entity surviving in a future downturn or one GSE requiring assistance to remain in business and "compete" with the other.

- FHFA should examine more closely, and seek public comment about, how to address the trade-off between having a desirable degree of product and price competition between the GSES and reducing operational complexity, perhaps by consolidating redundant GSE operations and functions such as loan boarding, pooling and investor reporting processes.

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 adjustment?

Answer.

Setting G-fees that reflect state legal idiosyncrasies that differentiate loan performance or increase recovery risks would be appropriate. This is far preferable to relying on compensatory fees to offset GSE state-level foreclosure management risks that are outside the control of servicers. It is important to reiterate that the need to address current uncertainty over servicing standards is as necessary as correctly pricing mortgage risk to restore balance to the U.S. mortgage market. If unaddressed, uncertainty over the application of servicing standards will unnecessarily constrain the availability of mortgage credit and potentially undermine the benefits of improvements in risk-based pricing.

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

Answer

- Insulating the GSEs from the CFPB's Qualified Mortgage ("QM") regime, through a circular approach that deems loans eligible for purchase by the GSES as QM, could hinder private market competition, by potentially reinforcing any mispricing of mortgage credit risk by the GSEs.

- GSE-eligible loans should be subject to the same QM definition as the rest of the market to ensure proper pricing of credit risk and optimal allocation of risk among investors according to their ability to price and bear such risks. Furthermore, GSE-eligible loans should be subject to QM standards to avoid compromising the GSEs' safety, soundness and systemic resiliency.