September 8, 2014

Federal Housing Finance Agency

Office of Policy Analysis and Research,

400 7th St., SW, Ninth Floor

Washington, DC 20024

**Via FHFA.gov**

**Re: Fannie Mae and Freddie Mac Guarantee Fees**

To Whom It May Concern:

You have requested input on a variety of questions relating to guarantee fee policy and implementation. I would begin by noting that g-fee policy can impact a whole lot more than what it appears to at first blush. Setting the rate too low can negatively impact the financial health of Fannie Mae and Freddie Mac (the Enterprises). It can also have a positive impact on housing prices because it reduces the overall cost of credit. Setting the rate too high can generate excess revenues for the Enterprises, which will impact Congress’ plans for them as well as possible outcomes for the investor lawsuits on the GSE’s conservatorships. And it would also have dampening effect on housing prices as it would increase the cost of mortgages.

I write in large part to directly address the political and legislative impacts of g-fee policy. This is a topic, I believe, that other commentators are less likely to address head on. I have only responded to your questions that relate to that topic. With that introduction, I turn to the specific questions that you set forth in your Request for Input.

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?**

In addition to the factors of expected losses, unexpected losses, general and administration expenses, the FHA and the Enterprises should set g-fees at a break-even point such that the Enterprises do not expect to generate profits. The g-fee should be broken into its components. If the FHFA, acting as the Conservator of the Enterprises, intends to fund the Housing Trust Fund, a portion of the g-fee should be explicitly set aside to do so. The existence of unallocated excess profits will distort the housing reform debate among members of Congress and the Administration. It may also unwittingly impact the various lawsuits arising from the conservatorship of the Enterprises as well as any reform plans under consideration by the FHFA itself.

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?**

The FHFA should seek to reduce the footprint of the Enterprises in the mortgage market. But the FHFA should not set the g-fee at a level higher than required to compensate taxpayers for guaranteeing the credit risk borne by the Enterprises. In an ideal world, credit would be priced according to risk. Other goals, such as increasing mortgage credit for low- and moderate-income households are legitimate policy objectives, but they should be pursued transparently by the FHFA.

Reducing the Enterprises’ footprint is also a legitimate policy objective. The FHFA can take steps other than raising the g-fee to reduce that footprint. For instance, it can shrink the conforming loan limit over time in order to reduce the number and size of mortgages that the Enterprises can purchase. This would allow Private-Label Securities (PLS) and portfolio lending firms to re-enter the mortgage market in a measured and deliberate way, with less of distorting impact on the cost of mortgage credit.

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?**

If the Enterprises continue to raise g-fees, it will cause the number of overall loan originations to decrease at least to some extent over the short term. This is because increasing prices will reduce demand for a given product all other things being equal. The market for mortgage credit is, however, a bit complicated. The Enterprises have a duopoly in the conforming market because their cost of credit is cheaper than it is for private lenders. But as soon as a g-fee increase raises the price of Enterprise mortgage credit so that it is equal to that of private lenders, there will be additional competition in the conforming market. This increased competition should put some downward pressure on the cost of conforming mortgages overall, but it would never push it as low as it would be if guarantee fees were set lower than what was necessary to compensate the Enterprises for the actual guarantee risk that they bear. That being said, the cost of mortgage credit should, in general, not be subsidized for most borrowers. And when it is subsidized, it should be done so transparently.

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?**

It is desirable for the Enterprises to engage in risk-based pricing without regard to its impact on FHA/Ginnie Mae. Overall the Enterprises and FHA/Ginnie have too great a footprint on the mortgage market, between 80 and 90 percent in recent years. This proportion is way out of whack with those entities’ historical footprints. That being said, it is not the FHFA’s mandate to determine the appropriate footprint for FHA/Ginnie. That is the responsibility of Congress as well as the FHA and HUD. While it is likely that higher g-fees on low credit score/high LTV loans will cause some of those loans to be insured/securitized through FHA/Ginnie rather than though the Enterprises, so be it.

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?**

It is an overall positive development for PLS and depository institutions to increase their market share at the expense of the Enterprises. While the PLS industry was responsible for much pain and suffering suffered by consumers and investors in the 2000s, there is reason to be hopeful that Dodd-Frank regulations will reduce the likelihood of such pain and suffering going forward. The new CFPB, for instance, is designed to protect borrowers from abusive lending. The Dodd-Frank Qualified Mortgage and Ability-to-Pay rules are designed to incentivize credit on reasonable terms that borrowers are likely to be able to repay. The Dodd-Frank proposed rule for Qualified Residential Mortgages is designed to incentivize originators of mortgages not to burn investors because of misaligned incentives in the securitization process. While the efficacy of these rules is untested, there is no reason to believe that the Wild West atmosphere of the pre-boom mortgage markets will soon reappear.

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?**

The FHFA should consider the following approaches as it balances its missions. First it should very clearly define the term “liquid national housing markets.” Many commentators refer to liquid markets loosely: what they really mean is cheap credit. A liquid credit market is not the same as a cheap credit market. Liquid credit means that there is sufficient credit to compensate lenders with an appropriate risk-adjusted return. Cheap credit means that credit is priced too low on a risk-adjusted basis. The United States’ secondary mortgage market is one of the most liquid in the world. That being said, it, like all markets, can suffer from liquidity crunches such as the one that occurred during the 2000s. Clearly, it is appropriate for the government to step in as lender of last resort during a liquidity crisis.

Some commentators also argue that the private sector does not have sufficient capital to fund credit on terms desired by most homeowners---30 year fixed rate mortgages. If, indeed, increased reliance on risk-based pricing were to lead to a major contraction in credit, it would be appropriate to revisit this issue. And if such changes were to lead to a reduction in credit to low- and moderate-income households, that too would be a reason to revisit this issue and potentially adopt policies that increased credit for that sector. Such policies, if adopted, should be stated explicitly and implemented transparently.

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

Each Enterprise should manage its own pricing. Pricing credit risk is not a science. One of the major problems in the years leading up to the Financial Crisis was herd behavior among financial institutions. Variations between the two Enterprises in terms of their risk-based pricing strategies should provide at least a minimal level of protection from herd behavior. While the two Enterprises may still act similarly, one can hope that the variation in their approaches could have at least a marginally positive impact if they turn out to have mispriced credit risk.

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?**

State-level pricing is a reasonable reaction to wide variations in state foreclosure regimes. It also provides states with an opportunity to reconsider their foreclosure regimes and to potentially change them. Extremely lengthy foreclosure regimes do not necessarily benefit state and local governments. Nor do they necessarily benefit mortgage borrowers. If the FHFA were to rely on state-level pricing going forward, it would be beneficial for the FHFA to clarifywhat a state would need to do to remove its state-level pricing component to the g-fee for mortgages in their jurisdiction.

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

The immense web of federal regulation of the housing finance market should be designed to work together to create a vibrant housing market. The secondary mortgage market stands on three legs, all of which are heavily regulated by the federal government. The first leg is made up of government instrumentalities like the FHA and Ginnie Mae. The second leg is made up of public/private hybrids like Fannie Mae and Freddie Mac. The third leg is the PLS market which is made up of private companies that package mortgage-backed securities that have no guarantee, explicit or implicit, from the federal government. Each of these legs buckled during the Great Recession.

The Qualified Mortgage (QM) definition will certainly have an effect on the conforming market and the pricing of conforming mortgages will certainly have an impact on the PLS market. How these effects will play out is not yet clear. For instance, will the QM rule allow for a vibrant non-QM market? What will pricing look like in the non-QM market? At what point would it be competitive with the conforming market? We cannot answer these questions at this early stage in the recovery of the PLS market. But federal regulations should be working together to track and respond to developments in as close to real time as possible.

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In *Auguries of Innocence*, William Blake writes,

To see a world in a grain of sand

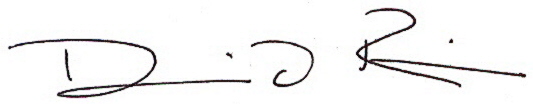
And a heaven in a wild flower,

Hold infinity in the palm of your hand,

And eternity in an hour.

The g-fee is much like the grain of sand, the wild flower of the mortgage market. While the g-fee appears to be a technical detail of our housing finance infrastructure, the decisions we make about it reflect our beliefs and desires about how that market is supposed to function and to what ends. We should make choices about it with care and attempt to think through, as much as possible, the consequences of those choices.

Sincerely,



David Reiss