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Federal Housing Finance Agency
The Honorable Director Sandra Thompson
400 7th Street, S.W.
Washington, D.C., 20219

Re: Arch MI's Response to FHFA's Request for Input on the Enterprises' Single-Family Mortgage Pricing Framework ("Pricing Framework")

Director Thompson:

Arch Capital Group Ltd., on behalf of itself and its subsidiaries ("Arch"), submits this letter in response to the Federal Housing Finance Agency's ("FHFA") request for input ("RFI") on Fannie Mae and Freddie Mac's (together, the "Enterprises" or "GSEs") Pricing Framework. Arch, through its insurance subsidiaries, provides commercial, institutional, and individual customers with mortgage, property-casualty, and reinsurance offerings on a worldwide basis.

Arch's subsidiaries, Arch Mortgage Insurance Company and United Guaranty Residential Insurance Company, (together "Arch MI") is a leading mortgage insurance provider in the United States, having $293.9 billion of insurance in force as of June 30, 2023. Arch's reinsurance subsidiaries are also leading investors in the GSEs' CRT programs covering $155.9 billion of insurance in force as of that same date. With significant exposure to mortgage credit risk, underwriting and pricing discipline to achieve an acceptable return is critical to how Arch manages its business. Thus, Arch is well-positioned to provide input on the RFI. Arch's comments are organized herein to address FHFA's specific requests for input on return on capital, components of G-fees, and process.

I. Return of Capital

Determining the appropriate long-term commercially reasonable return on capital threshold for the Enterprises is highly dependent on the business model being evaluated. Private corporations with shareholders typically target higher returns, than do public utility companies or government agencies. The Enterprises have been in conservatorship for 15 years, and the prospect of legislative action to address GSE reform is remote. Furthermore, the U.S. Department of Treasury has made commitments of financial support in the form of the Senior Preferred Stock Purchase Agreements. Thus, the Enterprises are functioning as the equivalent of government agencies. The Enterprises are generally earning mid-single digit returns on aggregate

new single-family acquisitions, which is similar to the returns of other government agencies.[1] Until such time as a different business model emerges and becomes reasonably likely, FHFA should consider the return thresholds of government agencies when determining the appropriate target for the Enterprises.

Next, Arch supports calculating the Enterprises return on capital based on the Enterprise Regulatory Capital Framework ("ERCF"). First proposed in 2018, reproposed in 2020, and amended further in 2022, the ERCF is based on robust analytic work by FHFA and the Enterprises, with substantial input across multiple comment periods from industry stakeholders. While no capital standard is perfect, the ERCF should provide a stable, transparent and risk-sensitive framework that is geared to ensure a durable capital standard across market cycles.

As FHFA notes in its 2021 G-Fee Report (published in November 2022), several features of the ERCF are not risk sensitive, such as the 20% loan level risk-weight floor and the capital buffers. As a result, the ERCF has a relatively flat risk gradient across credit characteristics, resulting in loans with stronger credit characteristics receiving more significant capital increases than loans with weaker credit characteristics, relative to prior proposed capital requirements.[2] To paraphrase an Urban Institute study that quantifies the impact of these risk-insensitive features, applying the 20% loan level risk-weight floor on the lowest-risk loans translates into 160 basis points of capital charges on nearly half of the loans the Enterprises acquire, which is 5 to 10 times the level of risk implied by these loans.[3] The FHFA may want to consider adjusting the risk-weight floor (or other risk-insensitive features of the ERCF) as necessary to better align the ERCF capital requirements with the risks implied by the loans acquired. In summary, Arch recommends that FHFA retain the ERCF (with potential adjustments) and require the Enterprises to maintain pricing levels calibrated to earn a targeted rate of return *at the portfolio-level* based on ERCF capital.

Finally, while FHFA should require the Enterprises to earn a targeted rate of return based on ERCF capital at the portfolio-level, this same target need not be applied uniformly on an individual loan basis. This point is particularly salient when considering the multiple objectives and statutory duties FHFA must balance, including potential safety and soundness concerns from the underpricing of mortgage credit risk, promoting a level playing field across lenders of different sizes, attracting private capital to the Enterprises, and improving support for creditworthy low- and moderate-income and underserved borrowers. Given these multiple objectives, Arch supports FHFA's differentiation of the Enterprises' acquisitions into three broad segments for assessing profitability and returns:

1. Mission-remote loans, such as second home and investment properties;

[1] https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/Single-Family-Mortgage-Pricing-Framework-RFI.pdf (Pg. 13)
[2] https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GFee-Report-2021.pdf (Pg. 9)
[3] How to Think About Fannie Mae and Freddie Mac's Pricing, *Urban Institute*, August 2023 at: https://www.urban.org/research/publication/how-think-about-fannie-mae-and-freddie-macs-pricing.

2. Mission-focused loans, such as loans made to low- and moderate-income borrowers; and
3. Standard purchase and rate-term refinance mortgage acquisitions that are not included in the first two segments ("Standard Business").

Arch agrees that differentiating G-fees and targeting a higher return on mission-remote loans to subsidize lower G-fees and a lower return on mission-focused loans is appropriate. The target return for the mission-remote segment should be a function of what the market will bear, while the target for the mission-focused segment should facilitate the Enterprises' duty to serve and affordable housing goals. Standard Business acquisitions, on the other hand, should be priced to achieve commercially reasonable aggregate returns across the economic cycle, including though the use of risk-based upfront G-fees.

II. Components of G-Fees

The Enterprises' business model prior to 2008 included flat G-fees that created market distortions, encouraged inappropriate risk-taking, and misled consumers by removing beneficial pricing signals. Let's not let history repeat itself. A flat G-fee structure would decrease secondary market liquidity and increase systemic risk by unnecessarily raising prices on a majority of acquisitions to subsize the underpriced higher credit risk acquisitions. Rather, Arch thinks it appropriate to utilize the ERCF's granular, risk-sensitive framework to determine the cost of capital and resulting upfront G-fees assessed on, particularly, Standard Business. The Standard Business segment constitutes a majority of loans acquired by the Enterprises, so managing this segment to ensure overall profitability targets is critical. Plus, basing upfront G-fees on the level of mortgage credit risk will prevent unnecessary price competition between the Enterprises and FHA.

III. Process

While Arch fully supports gearing G-fees (particularly in the Standard Business segment) based on the mortgage risk-sensitive ERCF, the Enterprises should also retain sufficient discretion to adjust pricing to address issues such as economic stress impacting liquidity or adverse selection. Absent these types of time-sensitive issues, however, FHFA should implement a formal process to solicit feedback from industry stakeholders prior to implementing material pricing changes. As FHFA well knows, pricing is a critical component of a lender's decision to deliver loans to the Enterprises or pursue an alternative execution. While FHFA has granted extended time periods to facilitate a smooth implementation of prior changes, Arch believes seeking feedback from the industry prior to making material pricing changes (particularly structural changes) will create less market angst and a more efficient feedback loop. With a formal feedback process, industry stakeholders could provide feedback on implementation complexities that could inform FHFA's published effective date and implementation timeline.

IV. Conclusion

In summary, Arch recommends FHFA determine the target rate of return, based on ERCF capital, by comparing the GSE's returns to other government agencies. The ERCF should provide a transparent and durable capital standard that should be used to set risk-based upfront G-fee pricing for the GSEs core business. Arch supports adjusting the ERCF as necessary, such as to make it more risk-sensitive, but cautions against abandoning the ERCF in its pricing framework. Arch also supports segmenting the business to enhance support for mission-focused lending, while requiring an aggregate rate of return at the portfolio level to ensure the safety and soundness of the Enterprises. Finally, Arch recommends the FHFA implement a formal process to seek feedback prior to implementing material pricing changes. Thank you for the opportunity to provide feedback on this important topic. Arch would be happy to discuss further at FHFA's convenience.

Sincerely,

Sara Millard