August 14, 2023

The Honorable Sandra L. Thompson
Director
Federal Housing Finance Agency
400 7th Street SW
Washington, DC 20219

Re: Request for Input on the Enterprises' Single-Family Pricing Framework

Dear Director Thompson,

Thank you for the opportunity to provide feedback on the Federal Housing Finance Agency's ("FHFA") request for input on the Single-Family Pricing Framework employed by Fannie Mae and Freddie Mac (jointly, "the Enterprises"). As always, we appreciate your willingness to consider industry input when evaluating key policies such as this. The Enterprises are vital to the health of the housing finance ecosystem not only as sources of liquidity, but as prime movers in the fields of underwriting, data analysis, pricing and other mortgage standards. Industry participants use the work of the Enterprises as the foundation for their own analyses. Even the non-Agency mortgage sector relies on many of the standards set by the Enterprises. Therefore, rigorous transparency into how and why such standards are set is critical to maintaining a healthy and well-functioning primary and secondary mortgage market. Specifically, candid insight into the Enterprises' pricing framework and philosophy allows all industry stakeholders to understand their mechanics and intent, ensuring that interpretations are well informed and that any criticisms or calls for reform are rooted in facts.

At Pennymac[1], we take pride in our role as a distinctive nonbank mortgage specialist with a strong focus on risk management, coupled with our expertise and resources. This focus enables us to maintain a dependable and steady channel for accessing capital and liquidity, benefiting both local mortgage banks and their clientele, as well as our own. In pursuit of that objective, we have diligently cultivated an unwavering approach to enterprise risk management, which includes a risk-centric method for valuing and pricing mortgage loans.

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[1] "Pennymac" refers to Pennymac Financial Services, Inc. (NYSE: PFSI) and Pennymac Mortgage Investment Trust (NYSE: PMT). PFSI is a publicly-listed specialty financial services firm with a comprehensive mortgage platform that is primarily focused on the production and servicing of U.S. residential mortgage loans and the management of investments related to the U.S. mortgage market. As of June 30, 2023, PFSI was the second largest producer and the fifth largest servicer in the U.S. according to Inside Mortgage Finance. PFSI also has $1.9 billion in assets under management. PMT is a publicly-listed mortgage REIT that specializes in residential mortgage investment strategies enabled by the operational and investment management capabilities of its manager and service provider, PFSI. PMT's investments focus on mortgage-related assets that are generated through its leading correspondent production business.

The FHFA has a commendable track record of effectively guiding the Enterprises toward implementation of resilient and comprehensive risk management practices. Given this impressive precedent, we firmly endorse the idea that FHFA should persist and amplify its engagement in shaping the pricing activities of the Enterprises. The impact of sound pricing strategies extends far beyond immediate financial gains; it plays a pivotal role in safeguarding the long-term health and sustainability of the mortgage market. By further integrating itself into the Enterprises' pricing dynamics, the FHFA can contribute to the cultivation of a transparent, fair, and efficient mortgage pricing landscape. At a high-level, the FHFA can effectively sustain and enhance its efforts by concentrating on five key components:

- Facilitate the proper identification of mortgage risks to the Enterprises by continuing to make small adjustments to the Enterprise Regulatory Capital Framework ("ERCF") to ensure that all risk-weighting analyses, which inform the Enterprises' capital requirements or pricing structure, most accurately measure credit risk and are based on empirical data.

- Enhance transparency in the Enterprises' pricing structure, encompassing the ERCF, Guarantee Fees, and other pricing mechanisms available to the Enterprises. Clearer and more accessible information about Enterprise pricing will foster market understanding, allow Enterprise Seller/Servicers ("Sellers") to fine tune their own risk models, and improve stakeholder buy-in.

- Ensure that the Enterprises have comprehensive pricing policies and procedures that holistically take into account all explicit and implicit pricing mechanisms which the Enterprises possess, validate the principles that are used to guide their policies, and require continued monitoring and analysis of their mortgage risk exposures.

- Require that the Enterprises provide sufficient prior notice to Sellers for any pricing-related adjustments, such that loans already in Sellers' pipelines remain unaffected by these changes and borrowers' mortgage costs are not negatively impacted.

- Maintain a level playing field among Sellers by identifying and prohibiting the misuse of the Enterprises' pricing mechanisms that do not encourage competition based on customer satisfaction, quality, and efficiency.

The FHFA's continued dedication to shaping the Enterprises' pricing activities can serve as a cornerstone for a more resilient, equitable, and forward-looking mortgage market. Below, we offer our observations of the components of the Single-Family Pricing Framework, including the Enterprises' use of other pricing mechanisms, as well as our recommendation for how the framework could be enhanced.

I. LEVERAGING THE ERCF FOR TRANSPARENT MORTGAGE PRICING

We believe that the primary component of the Enterprises' pricing calculations should be a recognition of the credit risk associated with the underlying loan given its characteristics that can be known at application. Only once the risk has been calculated based on each measurable loan characteristic should the Enterprises consider any adjustments necessary to meet revenue goals and ensure sufficient subsidization to meet affordable lending goals.

A. Aligning the ERCF's Credit Risk Assessment to Pricing

We strongly support the FHFA's use of the ERCF as a risk-based means to prescribe the levels of capital that must be held by each Enterprise. We also agree with the methodology used by the FHFA for calculating the capital requirements, which entails assigning risk weights based on observable loan level attributes. This provides the critical foundation upon which pricing should be set by the Enterprises in order to achieve their desired return targets. While the Enterprises have the ability to employ individual pricing strategies to achieve those targets, the capital requirement should start with the same foundational risk assumptions.

Just as the ERCF provides a methodology to assess differentiation in risk due to loan-level attributes, when setting mortgage loan pricing we believe that the Enterprises should allocate required capital to loans at levels that correspond to their risk attributes or level of risk. That is, lower risk loans should require less capital and higher risk loans should require higher capital. This capital allocation should be done first to establish a pure risk-based price for each loan before setting statutory or mission-based subsidies.

B. Refining the ERCF's Risk Weight Table

The individual loan level attributes and their associated weights detailed in the Risk Weight Table[2] within the ERCF are foundational to the Enterprises' pricing. Since they directly impact the primary market in the form of dictating higher or lower mortgage costs for consumers, it is important for the Risk Weight Table to be complete, accurate and transparent.

First and foremost, the Risk Weight Table should reflect all loan attributes that have statistically significant correlations to credit risk. One thing we have observed is that certain loan characteristics that were assigned higher capital requirements in the Conservatorship Capital Framework ("CCF") implemented in 2017 are absent from the current ERCF. Both loan size and the number of borrowers on a loan were included as risk attributes in the CCF and required higher levels of capital due to their higher risk correlation. Because lower balance loans and loans with single borrowers are also positively correlated with low to moderate levels of qualifying income we postulate that they were removed so as not to dissuade investment in this segment of the market.

We agree that removing regulatory hurdles and pricing incentives may be required to ensure all segments of the market are being well-served by the Enterprises. However, as stated above,

[2] 12 CFR 1240.33(d)(2), "Table 6 to Paragraph (d)(2): Risk Multipliers"

we believe that all risk factors should be accounted for in the Enterprises' capital requirements to establish a purely risk-based starting point. To ensure the Enterprises are able to continue providing mortgage liquidity for low- and moderate-income families, they could adjust their return targets for such loans. The necessity for this behavior is recognized in the charters themselves, which state that the economic return for such activities may be less than the return earned on other activities. In short, any subsidization that is required for the Enterprises to carry out their missions should be managed through their pricing strategies rather than capital requirements. In this way, the pure risk-weight of a loan remains discoverable.

Just as the Risk Weight Table should not exclude loan level risk attributes, it should not include risk attributes that cannot be assessed at a loan level. For example, third party originated loans are assigned an elevated capital charge, resulting in disparate risk weights by delivery channel. Having a risk weight based on the channel through which a loan is delivered is a departure from the rest of the framework as it attempts to account for risks involved with manufacturing quality rather than set loan level characteristics. While this is certainly a relevant risk factor to consider, it is not appropriate to account for it in such a nondiscriminatory way as to punish an entire sector of the lending community. Rather, such a risk basis should be derived at a counterparty level. We offer our thoughts on a potential structure for such an assessment in the final section of our response.

C. <u>Enhancing Data Quality</u>

Even taking into consideration all of the factors above when calculating risk-based capital requirements for the Enterprises, the resulting risk multipliers are only as good as the quality of data on which they are based. While our understanding is that FHFA excludes loans with now-prohibited characteristics from the datasets used for their default analyses, the vintages being used are still not fully reflective of other regulatory mitigants and technological advancements made with respect to loan quality since the Great Financial Crisis ("GFC"). On the regulatory front, the ATR/QM rule curtails risky lending practices by ensuring a borrower's ability to repay and incorporating certain mortgage product restrictions. TILA-RESPA Integrated Disclosures (TRID) enhances borrower transparency by standardizing loan term disclosures, which enables informed decisions and prevents defaults from hidden costs. The industry has also transitioned from solely being reliant on humans to manually collect and review underwriting documents to reliance on technology solutions embedded in the Enterprises' Automated Underwriting Systems ("AUS") to calculate and verify borrower information, in addition to validating compliance with underwriting policies contained in the Enterprises selling guides. In addition, borrower assistance options have also evolved substantially to further limit the impact on borrowers in economic distress. As a result of these developments we believe that, under the same macroeconomic conditions that were present during the GFC, the existing portfolio of Agency-eligible loans would produce lower frequencies and severities of losses.

D. <u>Transparency in Credit Risk Analysis</u>

Because the Enterprises' capital requirements are so consequential to both the safety and soundness of the Enterprises as well as their ability to carry out the requirements of their charters, it is important that the calibration of risk weights be done transparently and be grounded in empirical data that is available to all market participants. In a climate characterized by complex market dynamics, it is essential that industry stakeholders are equipped with the tools to thoroughly examine and comprehend the assumptions and calculations underpinning risk weight determinations. Such access empowers stakeholders to not only refine their own models but also to develop a more profound comprehension of the foundational principles shaping the Enterprises' pricing frameworks. This empowerment, in turn, fuels an environment where informed decisions can be made, ultimately contributing to more robust risk management practices and strategic pricing decisions. By openly sharing the risk weight calibration process, the FHFA bolsters not only the Enterprises' resilience but also fortifies the broader fabric of the mortgage market. Through this transparency, the public discourse surrounding any contemplated changes in Enterprise pricing becomes anchored in factual, data-driven assessments, dispelling unfounded speculations and fostering informed debates.

II. EXPLICIT AND IMPLICIT PRICING MECHANISMS, POLICY AND OVERSIGHT

A. <u>Enterprise Pricing Should Consider All Pricing Mechanisms</u>

The Enterprises have a number of pricing levers at their disposal, including Guarantee Fees, Pay-ups, Coupon Price Adjusters as well as other delivery requirements and restrictions which are used to shape the makeup of their portfolios and ensure the proper layering of returns and subsidies on the risk-based prices derived from the ERCF. We believe that discussions around Enterprise pricing should encompass the use of all direct and indirect pricing levers in use by the Enterprises. Below we describe each of these components and offer some of our observations regarding how they are being used currently.

B. <u>Feedback on Guarantee Fees</u>

The Enterprises' primary tools for pricing are ongoing and upfront (LLPA) guarantee fees. The upfront nature of LLPAs provides the Enterprises with surety from a cash flow perspective as the value of the fees are known and realized upfront, whereas the value derived from ongoing guarantee fees is determined by actual prepayment rates and cannot be known until the loan pays off. Until the Enterprises are well capitalized, the FHFA should focus future fee increases on upfront LLPAs to continue building capital reserves as quickly and safely as possible.

In the FHFA's Request for Input, the question is posed as to whether or not LLPAs should be eliminated altogether. We feel strongly that LLPAs should *not* be eliminated. Absent the ability to adjust upfront fees for known risk characteristics, the Enterprises' business model would mimic the pure cross subsidy inherent in the Federal Housing Administration's ("FHA") pricing. This would cause the Enterprises to have artificially lower pricing for riskier loans and artificially higher pricing for lower risk loans. This would leave them open to pricing arbitrage that would eventually erode the credit quality of their portfolios.

Furthermore, LLPAs play a pivotal role in establishing a fair and equitable mortgage market landscape. These adjustments not only ensure clear and easily understandable pricing structures but also uphold a consistent application of these pricing factors among all market participants, regardless of their size or scope. This adherence to uniformity resonates harmoniously with the overarching objective of the FHFA to foster a level playing field within the mortgage industry[3].

C. Feedback on Explicit Pricing Mechanisms

Pay-ups are used to target loans with specific attributes. For example, a common pay-up utilized by the Enterprises is related to loan balance. An Enterprise may pay up for low balance loans due to their lower prepayment risk, but such incentives can also be used to indirectly target other loan characteristics. Coupon Price Adjusters ("CPA") are used to better or worsen pricing for a specific coupon, product and issue month. CPAs may be applied based on characteristics including but not limited to origination channel, AUS and qualifying income level.

Recently, pay-ups have been employed to establish pricing incentives for lower balance owner-occupied purchase loans, aiming to capture a greater share of originations that meet the Enterprises' affordable housing goals criteria. This strategy arises from a positive correlation between low balance loans and low-income borrowers. Additionally, we have observed punitive pricing adjustments for non-goals loans. While we strongly support the Enterprises' pursuit of their single-family affordable housing goal targets, the utilization of pricing mechanisms can inadvertently deter non-goal pursuits. This can lead to increased borrowing costs for the middle-income customers served by the Enterprises or even a reduction in the origination of such loans. This effect is particularly prominent in an environment with insufficient mortgage originations to meet housing goals. We believe the FHFA should motivate and hold the Enterprises accountable for creating loan programs and pricing structures that foster homeownership growth and retention within the low- and moderate-income borrower segments and across the industry.

It is imperative that the Enterprises explore alternative avenues to fulfill affordable housing goals beyond the current methods of developing explicit pricing adjustments (or implicit pricing adjustments—as we will discuss below—such as market share restrictions, representative mix considerations or cross-delivery rules). While these techniques hold certain merits for other objectives, they do not consistently translate into direct and meaningful support for borrowers. Redirecting focus towards more substantive initiatives is essential, such as prioritizing down payment assistance programs that directly benefit borrowers by augmenting their financial capacity. Moreover, introducing innovative approaches like establishing a borrower escrow account designed to mitigate future delinquencies or implementing targeted loss mitigation programs can pave the way for sustained homeownership during times of adversity. By embracing these forward-thinking measures, the Enterprises can truly empower borrowers and foster a more resilient and inclusive housing market ecosystem.

[3] Federal Housing Finance Agency. (2022). 2023 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions. https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2023-Scorecard.pdf

While we acknowledge the potential of pay-ups and CPAs to prudently manage risks, moderate prepayment speeds, and promote affordable lending, the current implementation of such adjustments lacks transparency and equal application across all Sellers. Furthermore, the CPAs tied to origination channels employed by both Enterprises conflict with the FHFA's objective of maintaining a balanced competitive landscape among Sellers.

D. <u>Feedback on Implicit Pricing Mechanisms</u>

The Enterprises engage in the following activities that indirectly affect the pricing of loans, which results in restriction of a Seller's ability to offer borrowers the best available price for a mortgage. The following activities do not directly correlate to a given transaction in the primary market as they are not based on the risk profile of the borrower or collateral, however their use has a significant impact on price, and increases borrowing costs disproportionately for low to middle income borrowers, even when such levers are intended to benefit those same borrowers.

- *Market Share Restrictions* - To counterbalance disparities in the composition of Uniform Mortgage-Backed Security (UMBS) pools and minimize the potential of concentration risk, the Enterprises implement market share restrictions on deliveries for select Sellers. Nonetheless, these constraints inadvertently exert a negative influence on pricing dynamics. This results from the restriction that lenders face in providing borrowers with the most favorable loan pricing, tailored to the superior offerings of one Enterprise for specific loan attributes. The inherent challenge arises as mortgage loan pricing is specifically influenced by a lender's obligation to deliver loans to an Enterprise presenting a less competitive price to meet the stipulated market share requirements. As a consequence, these restrictions introduce complexities that hinder optimal pricing and warrant a comprehensive reevaluation to strike a harmonious balance between risk management objectives and pricing flexibility. Because it is not feasible to predict whether a loan will need to be redirected after it closes, lenders must blend the pricing between the Enterprises when deriving the cost of a loan for the borrower.

- *Representative Mix Requirements* - To mitigate the risks associated with adverse selection and ensure homogeneity in UMBS, the Enterprises require the delivery of a representative mix of loans to each. For example, a Seller must ensure that loans with similar credit profiles or prepayment risk characteristics are split evenly between the Enterprises regardless of which Enterprise pricing structure offers the most favorable loan price. As with the aforementioned market share restrictions, the requirement to deliver a representative mix when attempting to mitigate adverse selection risks, but when used incorrectly prevents lenders from being able to offer borrowers the most favorable price for their loans as there is no assurance that they will be able to deliver it to the Enterprise otherwise offering the best mortgage price.

- *AUS Limitations* - Despite the concept of homogeneity behind UMBS, each Enterprise may refuse to purchase loans underwritten with the other Enterprise's AUS, known as "cross-delivery." We have observed that the Enterprises engage in practices that selectively allow or disallow cross-delivery based on loan characteristics. For example, an Enterprise may refuse to accept cross-delivery of loans that do not contribute toward the achievement of its affordable housing goals. While we fully support sensible efforts to expand lending to low- and moderate-income borrowers, we do not believe that it should be managed through fungibility of loan deliveries. Again, such restrictions do not allow for transparent pricing and therefore cannot benefit the populations being targeted as intended.

While the current utilization of these policies and practices is driven by a valid intention to safeguard the Enterprises and MBS investors against inherent risks, it inadvertently inflicts negative consequences upon mortgage borrowers. This leads to less favorable outcomes for certain borrowers who are faced with higher mortgage costs, as well a pronounced imbalance in pricing across various Sellers. For example, exceptions to market share limitations are sometimes granted for loans with certain characteristics. As a result of this punitive competitive strategy, borrowing costs actually *increase*—absent other incentives embedded in LLPAs and other pricing modifiers. We believe that defining explicit principles for the utilization of the pricing elements mentioned earlier could offer a better approach for optimizing the factors that the Enterprises are responsible for addressing. This approach could also be more conducive to expanding financing for low- to moderate- income borrowers and others. The FHFA could achieve this by including in the pricing policy explicit instructions and guidelines for how, when and what purpose each restriction should be used.

E. Enterprise Pricing Policy and Oversight

In line with the FHFA's primary role as a safety and soundness regulator, the agency should ensure that the Enterprises do not engage in risk-taking that is not transparent or appropriate for current market conditions. In order to effectuate this, we believe that each Enterprise should maintain a comprehensive single-family pricing policy ("Pricing Policy") that articulates the principles which govern how each explicit and implicit pricing mechanism should be used, with specific alignment to the Enterprises statutory requirements and duty. The Pricing Policy should refer to and explain how each Enterprise relies on the ERCF and LLPAs, and how the Enterprise incorporates ongoing guarantee fees, pay-ups, CPAs, cross-delivery, and other volume limits to set the market price of each loan. The Pricing Policy should also explain how each Enterprise will continue to monitor and analyze its credit risk exposure and contain a clear methodology for future adjustments to each pricing mechanism, with thresholds that dictate the timing of such adjustments. The thresholds should include deviations from a standard range of overall pricing, as well as deviations from statutory requirements and goals. Thresholds could be based on macroeconomic conditions, housing market conditions or other economic indicators as seen fit. Importantly, the thresholds should be based on criteria that are transparent to all market participants so that changes can be anticipated. This type of comprehensive Pricing Policy would ensure that all pricing changes are appropriate for the current market, support the Enterprises mission objectives, and that changes are not deployed in a way that is disruptive to the smooth functioning of the secondary mortgage market.

F. Notice Period for Pricing Changes

The Pricing Policy should incorporate notice periods for pricing adjustments, allowing Sellers to accurately price loans during the origination process. The borrower's mortgage rate determination relies significantly on the loan pricing established by the Enterprises, encompassing guarantee fees, LLPAs, and explicit or implicit pricing factors. When a borrower secures their loan, the lender utilizes the current Enterprises mortgage price to predict the loan's future delivery value. Instances where a loan is finalized and delivered based on suddenly invalidated pricing assumptions, as observed in recent Enterprise pricing practices, introduce mortgage pricing volatility, resulting in unnecessarily elevated borrowing costs for consumers. To counteract the borrower impact of Pricing Policy changes, the Enterprises should institute ample notice periods for both explicit and implicit pricing changes. The effective date of such changes should align with future Application Dates. The duration of the notice period should be determined by the scope of the change and the lead time required for Sellers to implement the change. A Pricing Policy lacking adequate advanced notice of changes and pricing predictability for locked loans jeopardizes the integrity of the primary market.

III. MAINTAINING A LEVEL PLAYING FIELD

A. The FHFA's Role in Ensuring Pricing Parity

The FHFA has historically been focused on ensuring parity of pricing between Sellers of all sizes and setting a level playing field. As a result of this commitment, we witnessed a narrowing of pricing disparities that allowed a larger field of lenders to compete. When lenders are not afforded more favorable pricing based on volume alone, the industry must compete on customer service, quality and efficiency. Unfortunately, we have been witnessing pricing activities by the Enterprises that suggests a departure from the concept of pricing parity.

B. Disparate Pricing Due to ERCF Framework

A notable flaw in the Enterprises' pricing framework is the adverse treatment of pricing for third party originated ("TPO") loans. This unequal treatment seems to stem from the risk assessment attributed to TPO loans within the ERCF. In line with our risk-based pricing philosophy, where data and analysis support higher default expectations, we believe adjustments to risk-weighting and pricing are prudent. That being said, because the TPO surcharge is independent of individual loan characteristics, it is implied that the elevated risk profile is due to a difference in manufacturing quality or certain other characteristics not already accounted for in the ERCF. Attempting to capture credit risk attributable to manufacturing quality by origination channel may be too broad an approach given the advancements that have taken place in the mortgage industry over the last decade. As we have previously stated in our discussion about data quality, there have been significant technological and regulatory developments in the mortgage industry that have standardized the mortgage underwriting process and brought about changes that have strengthened safeguards and aligned origination processes across channels.

C. Disparate Pricing In the Direct Lending Channels

This is particularly relevant when examining the difference in processes between retail and broker originations, where manufacturing processes have become more similar over time. In both cases, the originator maintains the infrastructure that facilitates and oversees product development and product offerings, underwriting, and funding. In both channels, these functions are both governed by the same regulatory frameworks and (in the case of Enterprise loan products) leverage the same Enterprise AUS. The main difference is the borrower interaction. Retail originators employ loan officers who work directly with borrowers to guide them through the loan application process. With broker originators, borrower interactions are handled by a broker who acts as an intermediary between the borrower and the lender. Both loan officers and brokers utilize the tools provided by the originator and rely on the underwriting and funding infrastructure maintained by the originator. Furthermore, as industry origination volumes fluctuate and participants adjust capacity, there tends to be a strong level of migration between loan officers and brokers switching seats between retail and broker origination companies.

In light of these industry-wide developments and the convergence of manufacturing processes between retail and broker originations, it becomes increasingly evident that a retail originated mortgage loan is virtually identical to a broker originated mortgage loan. The underlying frameworks, safeguards, and risk management mechanisms remain consistent, further supporting the notion that equitable treatment in the pricing framework is both warranted and conducive to a more balanced and inclusive mortgage market landscape. While we understand the FHFA's and the Enterprises' desire to align pricing and capital requirements to risks associated with manufacturing quality or other non-loan level characteristics, this must be done with greater precision to ensure its effectiveness and a level playing field. Allowing the blended risk-weight to work its way into channel-based pricing is not appropriate, as the same loan with the same borrower or other collateral characteristics would be priced differently merely due to the fact that it originated in the retail origination channel versus the broker origination channel. In fact, the Enterprises could improve the quality of the loans they purchase by pricing for loan quality at a more granular Seller level rather than by channel, as we propose in detail below.

D. Disparate Pricing In the Correspondent Channel

Correspondent aggregators play an important role in the mortgage ecosystem by providing secondary markets expertise and liquidity to small banks and independent originators who lack the infrastructure to securitize loans. With this channel, originators benefit from doing business with private aggregators who maintain the eligibility to deliver loans to the Enterprises and infrastructure to serve as a technical resource for Enterprise pricing, underwriting, and securitization policies and practices. The Enterprises also benefit from doing business with private aggregators who are well-capitalized counterparties that provide an additional layer of risk mitigation. However, the Enterprises' cash windows—the most dominant aggregators in the industry—have a pricing advantage over other private aggregators.

This dynamic is somewhat contradictory given that the Enterprises lack a number of the risk-mitigating benefits that are provided by private aggregators. For example, at Pennymac, we enhance loan quality by conducting pre-purchase due diligence via loan review practices and we conduct strict counterparty monitoring and coaching. We also pride ourselves in being a well-capitalized counterparty who is both willing and able to meet our obligations with respect to representations and warranties. However, despite the added risk-mitigating advantages we offer, a loan sent directly to the cash window would secure more advantageous pricing than if it were delivered through a correspondent aggregator for MBS. This inconsistency runs counter to the principles of risk-based pricing and pricing equity. As previously emphasized, permitting a blended risk-weight to influence channel-specific pricing lacks appropriateness, resulting in disparate pricing for the same loan, bearing identical borrower or collateral attributes, solely based on whether it is directed to a private aggregator or the Enterprises' cash window.

In addition, the disparity in loan review requirements between the cash windows and private aggregators combined with the difference in pricing leaves the cash windows open to adverse selection. Currently, the cash windows end up purchasing loans that we have already declined to purchase due to their failure to meet our rigorous review standards.

This dynamic, however, is not limited to disparities in the review process between the cash windows and private aggregators. Indeed, Sellers across all channels employ varying degrees of risk management when producing loans and no two Sellers are the same, regardless of whether they operate in the same channel or not. As such, we propose that any pricing related to manufacturing quality be based on the evaluation of individual Sellers' loan quality and performance.

E. Proposal for Fairly Adjusting Price Based on Counterparty Quality and Performance

To appropriately adjust pricing so that it is truly commensurate with risk, the Enterprises could implement a comprehensive Seller quality and performance ranking system under the guidance of the FHFA. This system should strive to enhance transparency and accountability among the Enterprises' Sellers by establishing clear guidelines for originators to achieve different tiers of ranking and pricing incentives for favorable loan quality and performance. Under this proposal, the Enterprises would establish multiple tiers of ranking, each with specific criteria and performance benchmarks. The tiers could range from basic compliance to advanced levels of excellence, encouraging originators to continually improve their practices. It is critical that this system be fully transparent, with a defined set of performance metrics that evaluate key aspects of originator activities, such as loan origination quality, and compliance with regulatory requirements; as well as servicing activities that affect borrower outcomes and loss severities, if applicable. The criteria could even be expanded over time to include metrics around support for affordable housing goals or other mission objectives. This proposal would require the implementation of robust data collection and reporting mechanisms to ensure accurate and reliable assessments of originators' performance.

Providing clear, publicly-available guidelines on how to achieve each tier of ranking would put all Sellers on a level playing field and incentivize strong quality. These guidelines would include specific actions, best practices, and recommendations for enhancing their performance and moving up the ranking ladder. A system of pricing incentives could be used for Sellers who achieve higher tiers of ranking, such as preferential treatment in loan allocation, reduced fees, or enhanced access to secondary markets. This system could leverage the Enterprises' existing monitoring and review routines. Finally, we would recommend that the FHFA collaborate with industry experts, consumer advocacy groups, and other relevant stakeholders to gather input and feedback on the proposed ranking systems, ensuring that it aligns with the needs and expectations of all parties involved.

Through the establishment of a well-defined framework that enhances counterparty responsibility towards Enterprise goals, the Enterprises could potentially reduce their reliance on obscure pricing tools to fine-tune their outcomes. As the Enterprises increasingly integrate this structured approach, their dependence on alternative pricing mechanisms could proportionately diminish. In essence, the role of these other pricing mechanisms could be distilled to effecting minor interim modifications until more comprehensive changes can be seamlessly incorporated into the overarching counterparty system.

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We greatly appreciate the opportunity to contribute our perspectives and recommendations to the FHFA's evaluation of the Enterprises' Single-Family Pricing Framework. Our firm belief in the importance of a robust and transparent pricing mechanism aligns strongly with the FHFA's dedication to fostering a stable and equitable mortgage market. By continuously emphasizing risk management and transparency we can collectively forge a path towards a more resilient, competitive, and inclusive housing finance ecosystem that serves the best interests of both borrowers and the industry at large. Thank you for considering our input, we remain committed to actively participating in the ongoing dialogue and collaborative efforts aimed at refining and enhancing the pricing framework. Should you have any questions or wish to discuss further, please reach out to Oliver Rubinstein, MD, Chief of Staff, at (818) 746-2055 and Oliver.Rubinstein@pennymac.com.

Sincerely,

David Spector
Chairman and Chief Executive Officer
Pennymac