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Housing Finance & Regulatory Affairs

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August 4, 2014

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

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

Submitted via Electronic Delivery to: www.fhfa.gov

Dear Sir or Madam:

On behalf of the National Association of Home Builders (NAHB), I appreciate the opportunity to respond to the Federal Housing Finance Agency's (FHFA) Request for Input (RFI) on questions related to Fannie Mae and Freddie Mac (the "Enterprises") guarantee fee (g-fee) policy and implementation. Even as the Enterprises face an uncertain future, they continue to sustain the mortgage finance industry. The g-fees charged by the Enterprises have a significant impact on affordability of mortgage credit. Given the current extremely tight credit conditions, it is critical to consider the effects of g-fee pricing and policies on the housing market.

NAHB is a Washington-based trade association representing more than 140,000 members involved in all aspects of single-family and multifamily residential construction. The ability of the home building industry to meet the demand for housing, including addressing affordable housing needs, and contribute significantly to the nation's economic growth is dependent on an efficiently operating housing finance system that offers home buyers access to affordable mortgage financing at reasonable interest rates through all business conditions.

Background

As FHFA considers its responsibilities to maintain the safety and soundness of the Enterprises, it is valuable to examine the history of g-fee pricing and the strategic use of g-fees to achieve specific Enterprise and mortgage industry objectives. The Enterprises charge g-fees on mortgage loans they purchase from their lender and seller/servicer customers. The primary purpose of g-fees is to protect the Enterprises from projected credit losses due to borrower defaults and foreclosures. Additionally, g-fees are used to cover administrative costs and the cost of holding capital to protect the Enterprises against unexpected credit losses due to borrower defaults and foreclosures. The overarching value of g-fees is their significance to the mortgage-backed securities (MBS) market. Mortgage-backed securities issued by the Enterprises carry a guarantee of timely payment of principal and interest to

investors regardless of whether the underlying mortgage loans are paying as agreed or are in default. The credit risk guarantee supports the liquidity of the MBS market, a key mission purpose of the Enterprises, which benefits all housing finance market participants by lowering mortgage interest rates nationwide.

The most recent crisis in the housing finance market highlighted the fact that the Enterprises had not charged adequate g-fees to cover the costs of the defaults and foreclosures they experienced during the market downturn on mortgage loans in their portfolios and in the MBS they guaranteed. This realization at the start of the market decline in 2007 led the Enterprises to begin requiring new fees addressing credit risk. In November 2007, the Enterprises announced loan-level, risk-based delivery fees, determined by the combination of credit score, loan-to-value, property type, and loan type, would go into effect March 1, 2008. The following month, the Enterprises announced a second new fee would be charged on all mortgage loans purchased by Fannie Mac and Freddie Mac on or after March 1, 2008. This new upfront adverse market charge of 25 basis points was intended to protect against the heightened credit risk posed by deteriorating housing market conditions.

In December 2011, Congress passed the Temporary Payroll Tax Cut Continuation Act of 2011 (TCCA), which required the Enterprises to raise g-fees by not less than 10 basis points beginning on April 1, 2012. This fee is not kept by the Enterprises, but passed through to the U.S. Department of the Treasury until the requirement expires on October 1, 2021.

In August 2012, FHFA announced an additional g-fee increase of 10 basis points, effective later in the year. This increase reflected the higher estimates of the costs of bearing the credit risk of single-family mortgages calculated by the new pricing models implemented by the Enterprises in 2012. FHFA also directed the Enterprises to work toward more uniform g-fees. The Enterprises generally had established lower g-fees for lenders who deliver large volumes of loans as compared to those who deliver smaller volumes. Additionally, the Enterprises were directed to reduce cross-subsidies between higher-risk and lower-risk mortgage loans by increasing g-fees more on loans with maturities longer than 15 years that the increase in g-fees on shorter-maturity mortgage loans.

Though these fees (with the exception of the TCCA) cumulatively are intended to more accurately price the credit risk the Enterprises assume on the mortgage loans they purchase, they ultimately have made credit more expensive and less available for home buyers. The term g-fee is used comprehensively to include both upfront/delivery charges as well as ongoing fees. As all g-fees typically are incorporated into a lender's price and converted into the interest rate a lender charges a borrower, g-fees have an undisputed impact on affordability for homebuyers.

Current ongoing g-fees charged by Fannie Mae and Freddie Mac average more than 50 basis points – more than double their level prior to the Enterprises being placed in conservatorship in September 2008. In a recent publication, the Urban Institute shows that in the first quarter of 2014, Fannie Mae charged an average g-fee of 63 basis points on new single-family originations[1]. In addition, both Enterprises continue to charge the adverse market fee and add risk-based, loan-level price adjustments (LLPAs) at delivery. The LLPAs vary based on credit score and loan-to-value ratio and range from 50 to 325 basis points. To compensate for paying this delivery fee, a lender usually will convert this into roughly a 10 to 70 basis point increase in the borrower's interest rate.

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[1] http://www.urban.org/UploadedPDF/413160-Housing-Finance-At-A-Glance-A-Monthly-Chartbook.pdf

NAHB supports the concept that g-fees should be set at a level to cover the Enterprises' expected credit losses, unexpected credit losses, and administrative costs. This is prudent and protects the U.S. taxpayers as well as the financial system that remains heavily dependent on the Enterprises and still requires them to be financially safe and sound. Another bailout of the Enterprises could be catastrophic to the mortgage markets.

However, NAHB believes g-fees cannot rise indefinitely nor should they be established without taking into account the LLPAs, the adverse market charge and even the probable impact of the proposed new private mortgage insurer eligibility requirements. At some level, the piling-on effect of these costs will upset the balance between charging an appropriate level of fees to ensure the safety and soundness of the Enterprises and still achieving their charter mission to provide liquidity and support for affordable housing. Excessive fees will choke off access for mortgage loans on housing for low- and moderate-income borrowers and access to mortgage credit nationwide, including in central cities, rural areas and underserved markets, and generally erode affordable credit for the broad housing market. Reaching this tipping point is something the industry cannot risk at this time. The housing market is recovering slowly and the Enterprises' focus should be increased rather than decreased credit affordability.

NAHB Comments

Following the stated approach of Director Watt, NAHB's response to the Request for Input assumes the Enterprises will continue to operate in conservatorship, under the requirements of the Third Amendment to the Preferred Stock Purchase Agreements and their government charters. Still, the status of the Enterprises is somewhat vague – raising questions about how to balance their regulation, mission and profitability. Should the Enterprises be treated as fully government entities with an explicit federal government backstop and no control of their own destiny? Or, should they have some ability to continue to operate as private entities allowed to make business decisions that lead to profitable operations? Their nebulous state makes it challenging to answer the questions posed in the RFI. NAHB believes additional clarity and specific assumptions from FHFA would allow respondents to answer the questions based on a consistent understanding of how FHFA views the Enterprises' on the spectrum between government and private entities.

NAHB does not favor increases to g-fees that will affect mortgage affordability and availability. This is a long-standing policy of the association and it is reinforced in light of the current tenuous recovery of the mortgage markets and the tight availability of mortgage credit for borrowers. However, NAHB acknowledges that costs faced by the Enterprises are not fixed and g-fee increases may be justified from time to time. Conversely, setting g-fees to cover expected and unexpected credit losses and general and administrative costs using consistent and transparent data, also should allow opportunities for g-fees to decrease.

NAHB would like to take this opportunity to question the need to continue the upfront adverse market charges and LLPAs, i.e. risk-based pricing g-fees. These fees were originally implemented to better align mortgage pricing with credit risk. With declining foreclosure and delinquency rates, improving profitability at Fannie Mae and Freddie Mac, and a growing number of metropolitan areas returning to pre-recession levels of economic health, NAHB believes FHFA should eliminate or reduce the LLPAs, not increase them as was proposed in December 2013. Considering these upfront fees were unnecessary prior to 2008, NAHB believes improving market conditions in conjunction with new regulatory requirements such as

the Ability to Repay directive of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) have rendered them obsolete and they should be rolled back.

NAHB's Leading Markets Index supports our assertion that it is time for the Enterprises to eliminate the adverse market delivery charge in all states. Each month, NAHB publishes the NAHB/First American Leading Markets Index (previously the Improving Markets Index) which identifies metropolitan areas that are approaching and exceeding their previous normal levels of economic activity. More than 350 metropolitan areas are scored using a calculation that incorporates the number of single family housing permits issued, home prices and employment numbers for the past 12 months. NAHB's most recent Leading Market Index indicates that of the approximately 350 metropolitan markets nationwide, 56 have returned to or exceeded their last normal levels of economic and housing activity. Based on the current data, the nationwide housing market is running at 88 percent of normal economic and housing activity. Scores increased in 30 percent of the metropolitan markets in June and 83 percent of metropolitan markets have improved over the past year.

NAHB Response to Specific Questions

Question 1
Are there factors other than 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?

When setting g-fees, in addition to covering the costs of expected losses, unexpected losses, and general and administrative expenses, NAHB believes FHFA and the Enterprises should consider the impact of g-fees on the affordability of homeownership and the level of support provided by private mortgage insurance. NAHB does not believe g-fees should be set at a level to further public policy or to generate profits for the Enterprises.

The Enterprises continue to be responsible for supporting affordable homeownership and the level of g-fees, which typically are converted into higher mortgage rates, has an impact on affordability. NAHB's "Priced Out Model" estimates that as many as 1.2 million U.S. households can be priced out of the market for a median-priced new home by a quarter point increase in the interest rate on a 30-year fixed rate mortgage. As mentioned above, it is not unreasonable to assume that current LLPAs could increase the interest on a mortgage loan by at least 25 basis points. For example, if an interest rate increases from 4.25 percent to 4.50 percent on a $275,000 house (median new house price), the monthly principal and interest payment will increase from $1,284 to $1,321; the minimum income needed will increase from $71,777 to $73,382; and the number of households that can afford the house will decrease from 43,199,837 to 41,959,112 or by 1,240,725. (View NAHB's chart showing the number of households priced-out by interest rate increases.)

NAHB also believes the Enterprises may not be incorporating the full value of mortgage insurance when pricing g-fees and should make the value assigned to mortgage insurance more transparent to lenders. Though we understand pricing for a certain degree of counterparty risk, NAHB does not believe FHFA has taken full account of the fact that on mortgage loans with private mortgage insurance an Enterprise is in a less risky loss position - behind the borrower's equity and the mortgage insurer - than on mortgage loans without mortgage insurance.

FHFA states the largest determinant component of the g-fee is the amount of capital held against the risk of the mortgage. While FHFA states that the benefit of mortgage insurance is included in the estimated cost of the guarantee in Figure 3 of the RFI, it would be helpful if that were more transparent. It does not appear that required mortgage insurance on mortgages with loan-to-value (LTV) ratios above 80 percent is used as a mitigating factor in determining the g-fee. For example, on a loan with a 75 percent LTV, an Enterprise's exposure is 75 percent. On a mortgage with a 90 percent LTV, the average required mortgage insurance coverage of 25 percent reduces an Enterprise's exposure to 67.5 percent. On a 97 percent LTV, with mortgage insurance coverage of 35 percent, an Enterprise's exposure is 63 percent. In the RFI, Figure 3 shows the amount of capital and estimated cost to be significantly higher for mortgages with LTVs between 81-97 percent than that required for LTVs between 61-80 percent LTV leading NAHB to question whether the g-fees could be lower on some loans with mortgage insurance.

Finally, the Enterprises should not manipulate g-fees to promote public policy or generate corporate profits. NAHB does not believe g-fees should be set at a level the Enterprises determine would "crowd-in" private capital nor should g-fees be used to generate profits for the Enterprises while they are in conservatorship.

Question 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?

NAHB believes g-fees should be priced based on the considerations referenced in the response to Question 1 above. However, NAHB does not assume g-fees must be static. If the level of credit risk in the portfolio increases or decreases, thereby affecting expected and unexpected credit losses, adjustments to the ongoing g-fee may help the Enterprises more accurately address their credit risk.

Question 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?

With the current and ongoing express prohibition against building capital, it is unnecessary for the Enterprises to factor in a return on capital when setting g-fees.

Question 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?

At this point in the housing recovery, with no liquidity in the PLS market, it is very difficult to estimate the tipping point that would incent investors to reengage in the MBS market. Under Acting Director Edward DeMarco, FHFA was interested in finding this point in order to meet the

agency's self-imposed objective of reducing the Enterprises' footprint in the mortgage marketplace and "crowd-in" private capital. Encouraging the return of private capital and shrinking the Enterprises was considered necessary by Acting Director DeMarco to ensure the safety and soundness of the Enterprises and protect taxpayers from another potential bailout of the Enterprises – now with an explicit government guarantee.

NAHB did not agree with Acting Director DeMarco's approach. It is NAHB's position that it is not necessary to set g-fees at PLS or depository price levels to shrink the Enterprises' footprint, especially 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. NAHB believes it is the responsibility of Congress to determine the appropriate role of the Enterprises, set the parameters of housing finance reform and direct the actions of FHFA and others toward these objectives. NAHB's position is closely aligned with the approach of FHFA's current Director Mel Watt in which FHFA is focusing on the present status of the Enterprises and plans to manage them within the current statutory mandate and not base decisions and policy on what could or might happen in the future at the hands of Congress and the Administration.

Question 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?

NAHB believes if the Enterprises continue to raise g-fees, overall loan originations would decrease. There has been little evidence that private capital is sitting on the sidelines due to an inability to compete with pricing charged by the Enterprises. If g-fees continue to rise at the Enterprises, it is very uncertain whether borrowers who are priced out of the market for mortgages purchased by Fannie Mae and Freddie Mac would have other, more affordable options.

Question 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?

NAHB does not believe the Enterprises should use g-fees to drive loans to FHA/Ginnie Mae. First, as stated above, g-fees should not be used as a means to shrink the footprint of the Enterprises. Second, Fannie Mae and Freddie Mac MBS are, in effect, securities with credit guarantees explicitly backed by the federal government. The impact to the government and the taxpayer is essentially the same when a borrower defaults whether the mortgage is insured/securitized through FHA/Ginnie Mae or one of the Enterprises.

Question 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?

As stated above, NAHB does not believe g-fees should be used to shrink the profile or footprint of the Enterprises by attempting to drive loans to other entities.

Question 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?

FHFA should not increase the use of risk-based pricing. In fact, NAHB believes FHFA has shown no compelling data to support the level of risk-based pricing currently in place through the LLPAs and adverse market fee. NAHB considers risk-based pricing to be counter to the mission of the Enterprises, mandated by Congress, which requires them to accept lower returns for loans made to low- to moderate-income borrowers. Rather, risk-based pricing will likely cause low- to moderate-income borrowers to be disproportionately priced out of qualifying for a mortgage loan that the Enterprises would purchase.

NAHB supports setting g-fees to price for the overall level of credit risk in the portfolios of the Enterprises. If the level of credit risk in the portfolio increases or decreases, thereby affecting expected and unexpected losses, the g-fee can be adjusted. Tweaking g-fees will have less impact on credit-worthy borrowers who might otherwise be assessed an excessive risk-based price.

Question 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?

NAHB has concerns that the Enterprises rely too much on credit scores to determine a borrower's creditworthiness. The LLPAs are determined only by credit scores and LTV and do not take into account other borrower data that should be considered when assessing the credit risk of a borrower to Fannie Mae or Freddie Mac.

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

FHFA has stated its intent to manage Fannie Mae and Freddie Mac in their current state which remains two separate and unique companies. Within this framework, the Enterprises should be allowed to continue to manage their operations as distinct organizations.

Question 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?

For reasons stated in our response dated November 26, 2012 to FHFA's request for input on state-level pricing adjustments, NAHB remains opposed to any plan that calls for or encourages higher g-fees in specific states based on default costs FHFA considers excessive. We do not believe this is an appropriate policy for FHFA to require of the Enterprises. Even in their current state, the Enterprises still are subject to meeting their public mission of supporting a liquid

secondary market that supports affordable and available credit nationwide. NAHB believes home buyers in all states should be treated equally. Additional g-fees in targeted states will lead to an increase in mortgage costs for home buyers who did not contribute to the increased default costs the fees will try to mitigate. We do not believe consumers and homebuyers in select states should be targeted to pay this penalty.

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

NAHB believes there are two areas of interaction with the Consumer Financial Protection Bureau's (CFPB) Qualified Mortgage (QM) rule that FHFA should take into consideration when determining g-fee changes. The QM, defined by CFPB to meet the Ability to Repay requirement of the Dodd-Frank Act, has imposed rigorous and consistent income documentation and underwriting requirements on all originated loans. The ongoing impact of this rule will be consistently high credit-quality mortgage loans sold to the Enterprises. FHFA should consider the possibility that the need for risk-based pricing on a loan-by-loan basis is significantly reduced by this regulation.

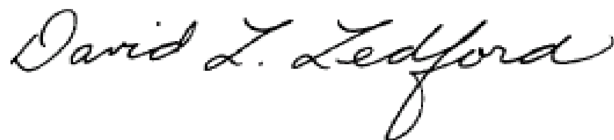
FHFA should consider whether increased ongoing g-fees and/or LLPAs will have unintended consequences for borrowers and lenders with regard to the degree of legal protection offered to a lender on originated loans. In particular, converting excessive fees into a higher interest rate could push mortgage loans into the category of QM loans with a rebuttable presumption which lenders may be less willing to originate.

Conclusion

NAHB appreciates that FHFA is soliciting input on g-fee policy and implementation. It is critical to consider the implications of the impact of g-fees on the market broadly. As discussed in our comments, we believe the impact on affordability to home buyers should be of paramount consideration in setting g-fees.

Thank you for your consideration of NAHB's comments. If you have questions, please contact Becky Froass, Director, Financial Institutions and Capital Markets, at 202-266-8529 or rfroass@nahb.org.

Sincerely,



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