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August 5, 2014

Federal Housing Finance Agency
Office of Policy Analysis and Research
400 7th St., SW, Ninth Floor
Washington, D.C. 20024
Submitted via FHFA.gov

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

Ladies and Gentlemen:

Genworth Financial's U.S. Mortgage Insurance business ("Genworth") is pleased to respond to the request by the Federal Housing Finance Agency ("FHFA") for public input (the "RFI") regarding the guarantee fees ("g-fees") of Fannie Mae and Freddie Mac (the "GSEs").[1] In this letter we will provide a brief overview of our views regarding g-fee policy and implementation, and we will then provide responses to certain of the questions included in your request for input.

As further discussed below, Genworth recommends the following regarding g-fees:

1. The increases proposed by former Acting Director DeMarco should be formally withdrawn from consideration.
2. The adverse market fees should be discontinued without implementing offsetting increases elsewhere. House prices have stabilized and there is no basis to continue imposing this fee.
3. Existing loan level fees based on FICO scores and loan to value (LTV) percentages should give full and transparent recognition for the credit loss mitigation from private MI and so should be eliminated or materially decreased. Instead of relying on loan level fees, the GSEs should consider charging a level guarantee fee for all loans that is set at an amount designed to cover expected and unexpected (stress) loss.
4. The GSEs should provide sufficient transparency into their pricing models, assumptions and loss severities to enable interested third parties to understand, evaluate and provide meaningful feedback on GSE pricing.

G-fee Policy and Implementation

Mortgage credit remains tight, and that is directly correlated to unduly high GSE pricing. GSE credit guidelines appear on their face to be fairly permissive, but the GSEs are not purchasing many loans that would fall within the GSE credit box. This disconnect between credit policy and GSE purchases has an especially large impact on borrowers with low to moderate incomes and first time homebuyers, *i.e.*, borrowers who are most likely to have moderate or lower FICO scores and who desire to purchase homes with less than a 20 percent down payment.

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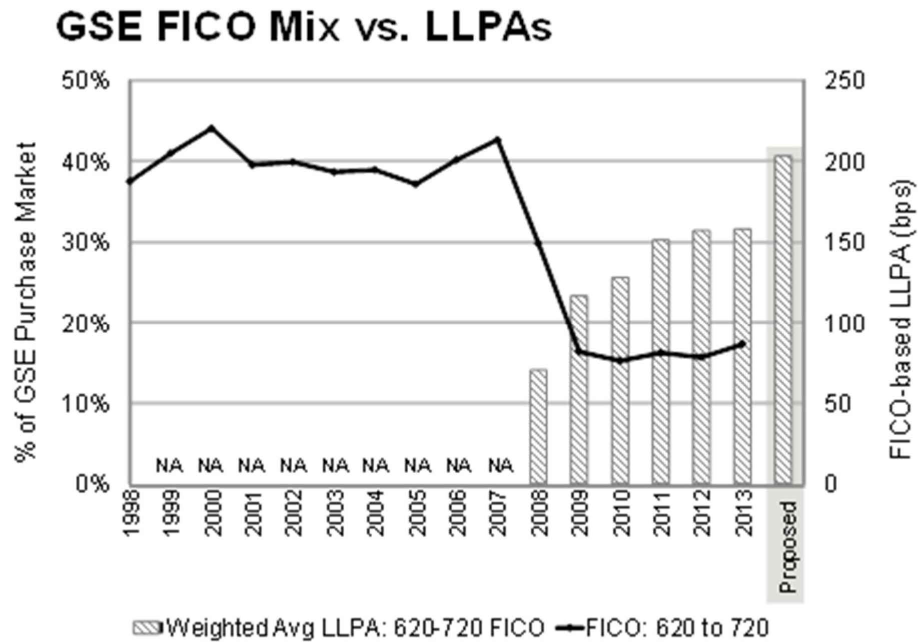
[1] *See FHFA* "Fannie Mae and Freddie Mac Guarantee Fees: Request for Input", (June 5, 2014) available at http://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/GfeeRFI060514F.pdf .

- The average FICO score for GSE loans is 748, and the average LTV ratio is 75 percent (excluding HARP loans), which together are far more restrictive than pre-bubble averages.[2]

- The percentage of loans purchased by the GSEs with FICO scores between 620 and 720 in the years prior to the 2005 - 2008 housing bubble was approximately 40 percent. The share of borrowers falling within that range fell precipitously in 2009 and still has not rebounded. As illustrated in the graph below, the decline in FICO scores corresponds to the implementation by the GSEs of FICO-based loan level fees.



Source: CoreLogic Loan Level Market Analytics Database[3] and Fannie Mae LLPA grids

GSE pricing is a material driver of this tight GSE purchase box. In particular, today's loan level fees that are determined based on FICO score and down payment result in borrower pricing that often makes a GSE loan more expensive than an FHA loan. (An example of this price differential is set forth below for a borrower with a 95 percent LTV loan.) As a result, current GSE pricing has the effect of pushing loans away from the GSEs to the FHA. The additional fees that were proposed by Acting Director DeMarco would have even further disadvantaged borrowers and pushed more market away from the GSEs to the FHA.

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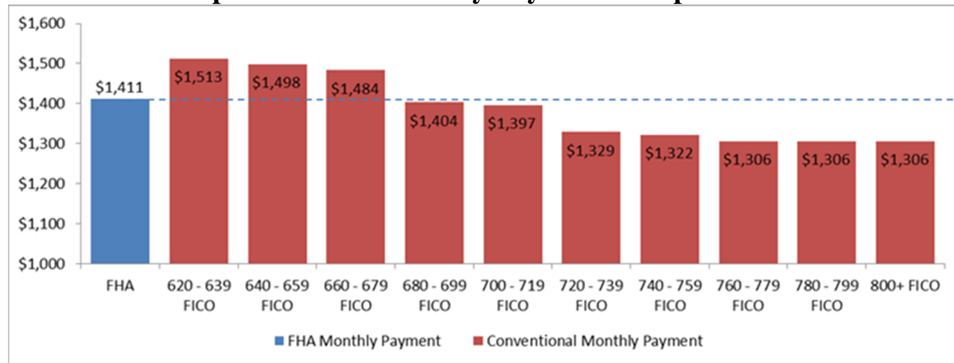
[2] *See* Fannie Mae's Credit Characteristics of Single-Family Business Acquisitions, 1Q14 available at http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2014/q12014_credit_summary.pdf, page 6 and Freddie Mac's Credit Quality of Single-Family Credit Guarantee Portfolio Purchases, 1Q14 available at http://www.freddiemac.com/investors/er/pdf/supplement_1q14.pdf, page 25.

[3] The CoreLogic Database is derived from loan servicer data and includes loan-level characteristic data and historical payment history. Further information regarding CoreLogic can be found at www.corelogic.com.

FHA vs. GSE – 95 percent LTV Monthly Payment Comparison – Current G-fees[4]



GSE loan level pricing based on FICO score and LTV is not commensurate with the risk exposure borne by the GSEs, and can – and should – be eliminated. For decades, the GSEs prudently priced for their guarantee via an across-the-board guarantee fee that applied to all loans, with a limited number of additional fees assessed based on certain loan terms – but not on borrower credit or the amount of down payment. There is no need for the GSEs to continue with the risk based pricing that was implemented during the height of the crisis, especially given the current suspension of their regulatory capital requirements and the significant regulatory reforms (such as the QM rule) that now govern the mortgage market.

Proposals to reform the GSEs or otherwise change their legal status, or material changes in the size or tenor of the mortgage market, may require reconsideration of the important questions of how best to capitalize the housing finance system and how best to allocate costs to borrowers. Our responses, however, are premised on today's economic, regulatory and legislative environment.

Responses to Numbered Questions

Question 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?

G-fee pricing should take into consideration expected and unexpected losses and operating expenses. A return on capital should not be a factor given the GSEs' status in conservatorship, the effective suspension of regulatory capital requirements, and the GSEs' statutory obligation to promote liquid and resilient markets.[5] Given the still fragile housing recovery, when setting pricing, the GSEs must balance sound credit policy with the need to ensure that creditworthy borrowers have access to affordable mortgage credit.

In addition, when factoring expected and unexpected losses into pricing, the GSEs must give effect to the credit risk mitigation afforded by private mortgage insurance. Under the current scheme,

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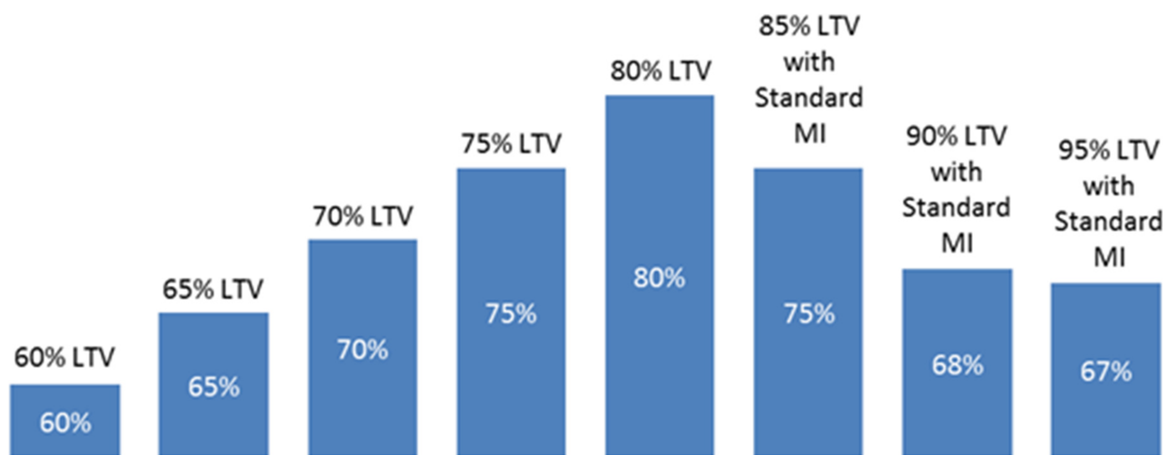
[4] Assumes $250,000 house price, 30-year term, 3.50 percent pass-through rate, 4 percent base note rate (before g-fee and LLPA adjustments), 5 year annualization factor, 100 bp GNMA bond price advantage (resulting in 20 bp rate advantage) and annualized g-fee of 42 bps (direct note rate impact), based on average LLPA (LLPAs vary based on FICO but average 13 bps). Genworth filed MI premium rates used to determine GSE monthly payment.

[5] On October 9, 2008, FHFA announced that it "will continue to closely monitor [GSE] capital levels, but the existing statutory and FHFA-directed regulatory capital requirements will not be binding during the conservatorship." http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Suspension-of-Capital-Classifications-During-Conservatorship-and-Discloses-Minimum-and-RiskBased-Cap.aspx.
The Housing and Economic Recovery Act of 2008 (HERA) states that "the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets (including activities relating to mortgages on housing for low-and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities), 12 U.S.C. § 4513(a)(1)(B)(ii).

borrowers with similar FICO scores generally are charged the same g-fee for comparable loans with LTVs above 75 percent, even though the exposure borne by the GSEs is reduced on loans subject to MI coverage. As illustrated in the graph below, the exposure borne by a GSE for a loan with an above 80 percent LTV is *less* than that of a lower LTV loan due to the default mitigation provided by MI. However, in spite of their lower risk exposure for higher LTV loans that are covered by MI, the GSEs are charging the same fee on all loans with LTVs of 75 percent or greater.[6]



Genworth does not dispute the fact that loss experience on higher LTV loans is greater than on lower LTV loans when all other features are held constant. That is precisely why the GSEs' charters require credit enhancement on loans with LTVs above 80 percent and why, for decades, the GSEs have required "standard coverage" MI at levels that are greater than the minimum MI coverage levels legally required by the GSEs' charters. The system was designed to ensure that private, third party risk bearers assumed the incremental risk arising from higher LTV loans.

Notwithstanding the credit risk mitigation afforded by private MI, the GSEs introduced loan level fees based on FICO and LTV in 2008. At that time, the mortgage market was in crisis, mortgage defaults were at unprecedented high levels, the GSEs were put into conservatorship, and there was absolute uncertainty regarding the future of the mortgage finance market. Today, mortgage default rates continue to fall as housing markets recover, and new mortgages are being originated under the prudent standards of the QM rule. The GSEs remain in conservatorship, but the MI industry has recapitalized through organic earnings (*i.e.*, premiums received) and has attracted over $9 billion in additional private capital including capital raised by several new industry entrants. On October 1, 2014, revised master policies will become effective that will provide improved clarity regarding an MI's obligations to pay claims. FHFA has published revised GSE eligibility requirements that, when finalized, will heighten GSE oversight of MIs and will increase capital requirements, and state regulators have begun a major effort to update the MI model. In light of these developments, now is the time to significantly reduce, or eliminate, the surcharges introduced by the GSEs during the height of crisis.

The current loan level pricing for loans with private MI is excessive. When the GSEs purchase a loan with mortgage insurance, their exposure to risk of loss from default is significantly reduced, and in many cases entirely eliminated. Yet today, loan level fees charged by the GSEs for their minimal

[6] For borrowers with FICO scores above 699.

remaining remote risk are 25 percent higher than the premiums private MIs charge to assume first loss.[7]

Recent GSE risk-sharing transactions (STACR and CAS offerings) provide further evidence that current GSE pricing is excessive. For example, Fannie Mae's CAS 2014-02 transferred approximately three percent of Fannie Mae risk on above 80 percent LTV loans to bondholders. Fannie Mae retained the first 65 basis points of loss on those loans. Assuming an extreme stress event resulted in losses that exhausted Fannie Mae's 65 basis points of retained first loss, and allocating seven basis points to operating expenses (per the RFI), the CAS offering implies that Fannie Mae should be charging borrowers a g-fee of 36 basis points for high LTV loans with MI. Instead, the GSEs are charging borrowers between 52 and 112 basis points (the fee varies based on FICO score) for that risk. Based on this analysis, either the CAS offering was materially underpriced or g-fees are materially overpriced.

Finally, we note that, based on the information included in the RFI, current GSE pricing results in an operating margin of approximately 80 percent or 34 bps (average annualized g-fee of 55 bps (45 bps without giving effect to the 10 bps fee paid to the U.S. Treasury under the TCCA), minus the average expected credit cost of four bps and minus the G&A expense of seven bps).[8] By comparison, Genworth targets an operating margin of approximately 50% for assuming first loss on low down payment mortgages. Eighty percent operating margins are inconsistent with the status of the GSEs in conservatorship and arguably are inappropriate for GSEs regardless of their status, especially since they are assuming remote risk on the mortgages they guarantee.

Going forward, we urge FHFA to require the GSEs to make publicly available the specifics of their pricing models, loan level loss severities and underlying assumptions regarding expected and unexpected losses to ensure transparency of pricing and enable third parties to undertake independent, arms-length analysis of GSE price adequacy.

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?

We agree that the risk to the GSEs is a function of the mix of business guaranteed. The possibility of shifts in mix could be addressed through very granular risk-based pricing. However, that approach has clear implications for housing policy because it will result in the least risky loans (typically, loans to higher net wealth and repeat borrowers) getting lower – possibly materially lower – pricing than loans to first time homebuyers and borrowers with low and moderate incomes. For this reason, serious consideration should be given to an approach that distributes some risk of loss across borrowers, resulting in more level pricing.

Before the advent of exotic mortgages and inflated house prices, the GSEs were able to price for their guarantee through a single guarantee fee, with limited additions to pricing for specified loan terms. No additional fees were levied based on FICO score or on LTV percentage. Given the QM rule's constraints on exotic mortgages and the ongoing housing market recovery, the GSEs can implement less granular pricing that is designed to cover expected and unexpected loss. The mortgage market is dynamic and credit risk profiles shift over time, but it is possible to monitor market metrics and

[7] For a 90 percent LTV, 680 FICO loan, the MI premium is 57 basis points versus g-fee of 72 basis points.
[8] *See* RFI, page 5.

identify shifts in mix that may have a material impact on risk in a timely fashion and to adjust pricing (perhaps quarterly or annually) to reflect any material market shifts that increase (or decrease) risk. Going forward, consideration should be given to the use of deeper MI (both deeper coverage on above 80 percent LTV loans and new coverage on lower LTV loans) as a cost effective way to further offset risk and mitigate the risk of volatility for the GSEs.

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?

If FHFA elects to reinstate regulatory capital requirements for the GSEs while they remain in conservatorship, the amount of capital should be determined based on expected and unexpected loss. Pricing to a target return on assumed capital that is based on private sector pricing assumptions appears excessive given the GSEs' status in conservatorship, the effective suspension of regulatory capital requirements and their statutory obligation to promote liquid and resilient markets.[9] We note that a target risk-adjusted return on capital of up to 15 percent far exceeds the average 10 percent returns private MIs have experienced over the past 35 years for first risk of loss (versus the GSEs remote risk position).[10]

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?

Investors, portfolio lenders and secondary market issuers consider a variety of factors when making an investment decision. Pricing alone is not dispositive. In today's market, investors have cited regulatory uncertainty, repurchase risk and capital management as material issues. Increased GSE pricing can, and often does, have the effect of simply shifting market away from the GSEs to the government insured FHA program. The chart below shows the market share for PLS issuance compared to increases in g-fees. We see no meaningful evidence to support the idea that GSE pricing is effective to "crowd in" a PLS market.

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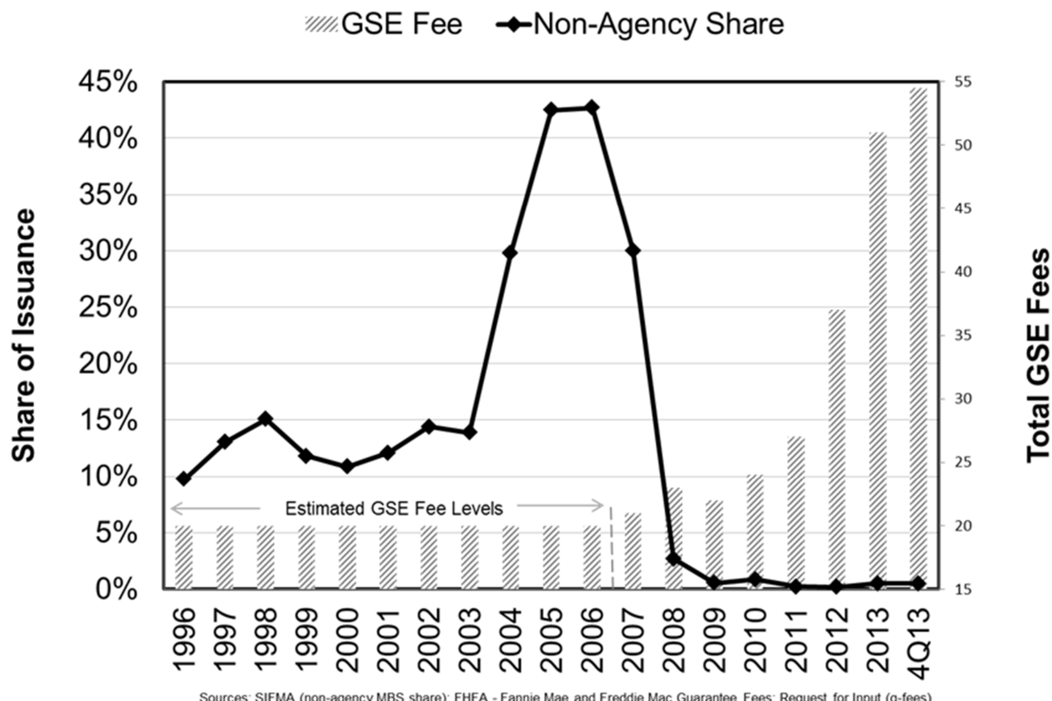
[9] On October 9, 2008, FHFA announced that it "will continue to closely monitor [GSE] capital levels, but the existing statutory and FHFA-directed regulatory capital requirements will not be binding during the conservatorship.", http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Suspension-of-Capital-Classifications-During-Conservatorship-and-Discloses-Minimum-and-RiskBased-Cap.aspx.
The Housing and Economic Recovery Act of 2008 (HERA) states that "the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities), 12 U.S.C. § 4513(a)(1)(B)(ii).

[10] *See* "U.S. Private Mortgage Insurance", Fitch Ratings, January, 2003; "U.S. Mortgage Insurers", Moody's Investors Service, February, 1997; "The State of the PMI Industry", Duff & Phelps Credit Rating Co., December, 1995; "U.S. Private Mortgage Insurance", Fitch Ratings, December, 2006 and latest available company annual statements for legacy MI companies (Genworth, MGIC, Radian and United Guaranty).

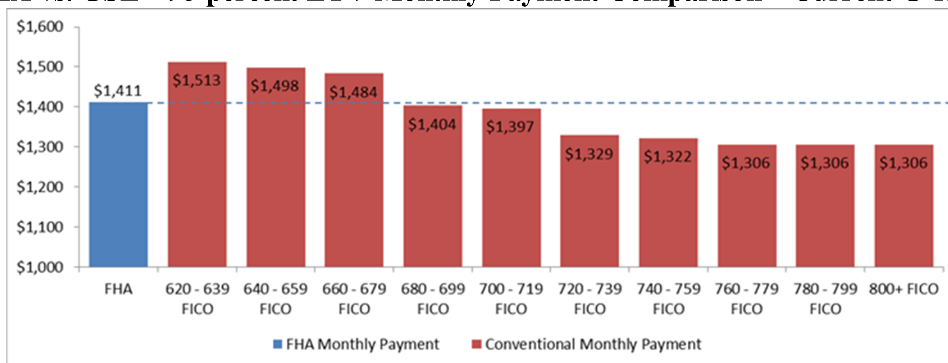


Question 5: If the Enterprises continue to raise g-fees, will overall loan originations decrease? That is, will Enterprise loans decline without a commensurate increase in private capital?

If g-fees increase, the most likely effect will be to push more borrowers to the FHA. Some potential homeowners will defer the purchase decision. Others will devote more of their monthly cash flow to their mortgage payment, dip into cash reserves to increase their down payment (if they have enough savings to do so), buy a lower cost home than their credit history would otherwise permit or defer the purchase entirely. None of these are good outcomes for families, for the housing markets or for the broader economy.

The table below compares the borrower payment for a 95 percent LTV loan with FHA insurance to a comparable loan purchased by the GSEs, giving effect to current loan level pricing.

FHA vs. GSE – 95 percent LTV Monthly Payment Comparison – Current G-fees[11]



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?

No. Credit worthy borrowers should have access to fairly priced loans purchased by the GSEs. This is consistent with long standing Administration policy of returning the FHA to its "traditional role as a targeted provider of mortgage credit access for low-and moderate-income Americans and first time homebuyers."[12] GSE pricing that pushes borrowers who would not otherwise need this targeted assistance to the FHA is inconsistent with the historical role of the FHA and with sound housing policy.

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?

Higher pricing will not have the effect of causing more loans to be insured/securitized by PLS. See our responses to questions 4 and 5.

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 direct the GSEs to return to greater reliance on pricing through level g-fees. Doing so is consistent with the HERA mission requirements and can be a simple and effective way to ensure that pricing is commensurate with expected and unexpected risk. See our responses to questions 1 and 2.

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[11] Assumes $250,000 house price, 30-year term, 3.50 percent pass-through rate, 4 percent base note rate (before g-fee and LLPA adjustments), 5 year annualization factor, 100 bp GNMA bond price advantage (resulting in 20 bp rate advantage) and annualized g-fee of 42 bps (direct note rate impact) based on average LLPA (LLPAs vary based on FICO but average 13 bps). Genworth filed MI premium rates used to determine GSE monthly payment.

[12] See, *e.g.,* Department of the Treasury and U.S. Department of Housing and Urban Development, "Reforming America's Housing Finance Market - A Report to Congress" Feb 2011, available at http://portal.hud.gov/hudportal/documents/huddoc?id=housingfinmarketreform.pdf.

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?

As discussed in our responses to questions 1 and 2, today's loan level fees based on FICO score and LTV are excessive and should be significantly reduced or eliminated. Moreover, the GSEs continue to charge borrowers an "adverse market fee" of 25 basis points. That fee was introduced during the height of the market downturn when house prices were experiencing rapid depreciation. There is no basis to continue charging the adverse market fee now that housing markets across the country have stabilized. We note that all private mortgage insurers have eliminated any declining market fees they introduced during the crisis.

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

G-fees can impact the calculation of fees for purposes of QM's cap on points and fees and the determination of the APR spread over APOR. Unnecessarily high fees will have a greater impact on these calculations.

Conclusion

Genworth appreciates this opportunity to respond to the RFI. Questions or requests for further information may be directed to the undersigned or to Carol Bouchner (carol.bouchner@genworth.com) or Duane Duncan (duane.duncan@genworth.com).

Very truly yours,

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