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Federal Housing Finance Agency
400 7th Street SW
Washington DC 20024

To Whom It May Concern:

We are writing this comment in response to FHFA's request for input on guarantee fee ("g-fee") policy and implementation.

Throughout the post crisis recovery, the GSEs have been the leading provider of mortgage credit. Over this period, nearly 90% of new mortgage originations have some kind of government sponsorship, via Fannie Mae, Freddie Mac, FHA or VA. Also during this period, the FHFA lead an increase of G-fees which has assisted the GSEs' return to profitability. Further changing g-fees can be viewed as facilitating the consensus need to shrink the GSEs footprint, assuming borrowers are not left with no or limited access to credit. However the FHFA raises some concerns on how changing g-fees will shift supply to other sources of credit, notably the FHA and private label markets. Furthermore should private label lending increase, it is unclear if private label securities ("PLS") issuance will follow.

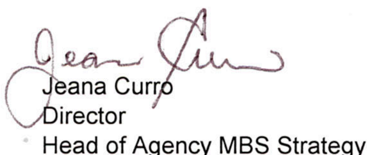
The RBS view is that going forward, it would make sense for the GSE model to cover smaller (conforming) balances and good (although perhaps not pristine) credit. A reduced GSE role should reduce the risk ultimately taken by the taxpayers and if sizeable, should help the growth and liquidity of the PLS market. RBS firmly believes that g-fees are a lever, but not an exhaustive lever, that can be used to revive the PLS market. While we understand that loan limits are not being examined by the FHFA at this time, we believe lowering the conforming and high cost limits would also stimulate private label lending, which would eventually lead to private label securities growth. With the private label market becoming the predominant source of credit for pristine jumbo and non-QM loans, the GSEs could focus on middle class lending.

RBS also suggests that the FHFA look at introducing loan size as a third factor (alongside LTV and FICO) in setting g-fees, with higher loan balances paying higher fees, ceteris paribus. We believe this structure could achieve the same effect as would lowering loan limits: shifting larger loans into the private label market.

While we believe altering g-fees will help change the relative market share of the GSEs vs. FHA and private capital, we emphasize that it is not a cure-all. The below factors, many of which lie outside the FHFA realm, have all contributed to the muted PLS market recovery. Only when the below are resolved do we expect to see meaningful PLS growth.

- Lack of regulatory clarity: there are a whole host of rules that have yet to be finalized including QRM and Regulation AB2. Until this occurs, we expect securitization levels to remain muted and investor interest selective.
- Looming rise in interest rates: It is less appealing for lenders to issue fixed rate loans at such low rates with higher rates likely on the horizon. Additionally, securities have mark-to-market risk (loans however do not), therefore holding loans in portfolio (in lieu of bonds) is sensible in the event of a rate backup.
- Lingering scars from crisis: Now almost six years into the post-crisis recovery, PLS litigation is ongoing and PLS investors still have a general mistrust of servicers and trustees. Although significant progress has been made to alleviate these concerns, there is more work to do.

In the following pages, we provide our answers to questions 4, 5, 6, and 7. Thank you for your consideration and time.



Jeana Curro
Director
Head of Agency MBS Strategy

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4. At what g-fee level would 1) ***private-label securities (PLS) investors*** *find it profitable to enter the market or would 2)* ***depository institutions*** *be willing to use their own balance sheets to hold loans? 3) Are these levels the same? 4) 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?*

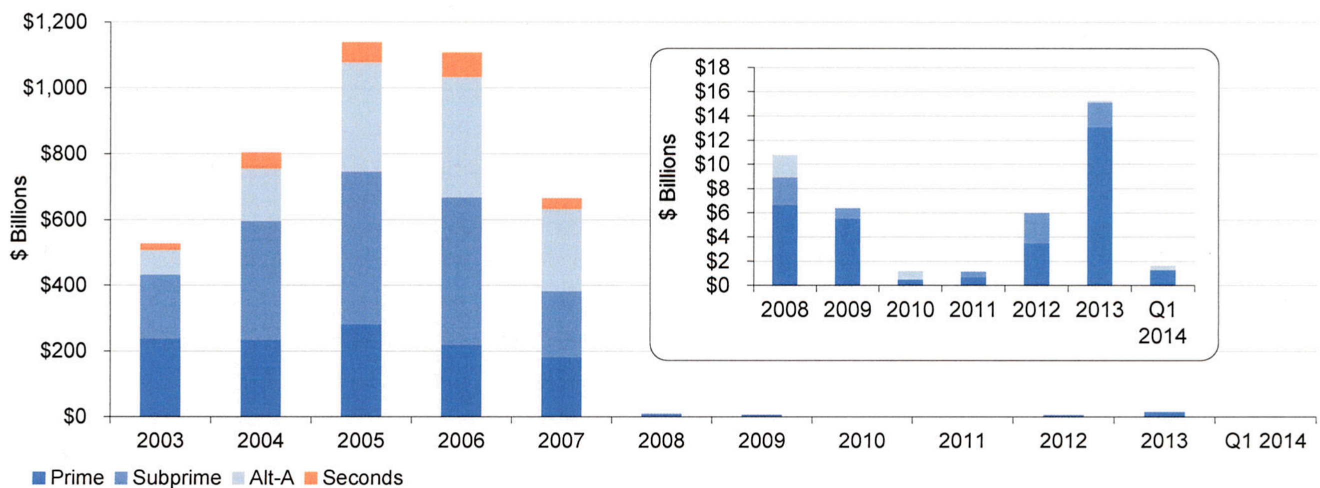
4.1 Addressing the first part of this question, it is difficult to quantify an absolute level number where private label investors would be willing to enter the market. However, we do currently see strong investor demand for credit-sensitive mortgage exposure, largely due to a general low rate/low yield investment environment. For example, a recent new issue AAA RMBS bond (WIN 2014-1 A1, priced 6/19/14) with a 4% coupon, 4.5 year average life launched at 103-12, or a spread of 155/swaps.

The above is a starting point, but if the FHFA is concerned over the strength of the PLS market at this time, there are a few things that need to be addressed. Here is just a short list of concerns:

- PLS supply is extremely light (and has been post crisis) and underwhelms demand. Because anaemic issuance (chart below) is making it difficult for PLS investors to find bonds, we believe investors are willing to accept tight spreads. Therefore the above levels can be used as a starting point, but may not be accurate reflection of demand in a robust PLS market.

- Any increase in supply may create demand, however investors are not likely to invest if they do not believe the asset will be issued in size or have good liquidity in the secondary market. For example, RBS recently brought down to the White House CIOs from 10 of the largest insurance companies and learned that all 10 were actively buying AAA CMBS. However, only one of these 10 was buying AAA Private Label RMBS. When we asked the other 9 why they were inactive in RMBS, each acknowledged that the Government's near-omnipresence in the market (supporting roughly 90% of housing through GSEs) was the main deterrent. All 9 also said that if the number returned to a more "normal" level of around 60%, they would all be involved. Given this investment behavior, we believe that a sizeable reduction in government scope is near necessary to not only crowd in the PLS market, but also to encourage meaningful supply and ensure its liquidity.

Non-Agency Issuance: Post-Crisis Volumes Pale in Comparison to Pre-2008; Likely to Stay Muted in 2014



Source: Inside MBS & ABS, RBS.

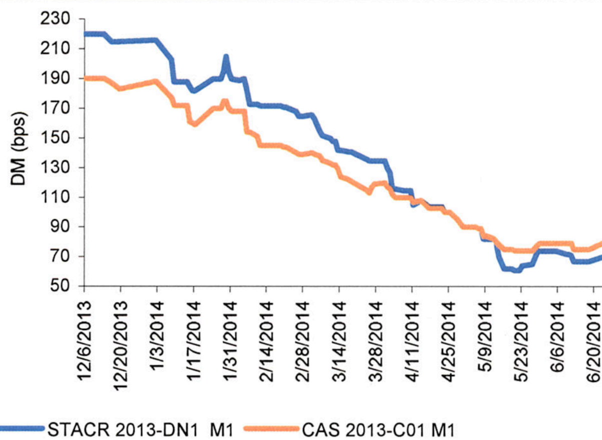
- AAA investors are sidelined due to the lack of clarity and uniformity in the trust documents. There are still lingering scars from the crisis on how and when investors receive payments. We know the FHFA is currently making progress on the Common Securitization Platform. Should the platform permit some kind of standardization for payment rules for PLS, it would be a strong selling point for PLS investors.

- For bank portfolios, the Liquidity Coverage Ratio (beginning phase in January 2015) is unfavorable towards non-agency MBS securities. As per the latest NPR release, non-agency RMBS do not count at all towards the high quality liquid asset ("HQLA") calculation. Essentially, full -recourse non-agency MBS would receive Level 2b classification, meaning that they are capped at 15% of HQLA and are subject to a 50% haircut -- however US RMBS are all "non-recourse" and therefore excluded. FN and FRE MBS currently receive Level 2a classification, meaning they are capped at 40% and are subject to a 15% haircut. This is

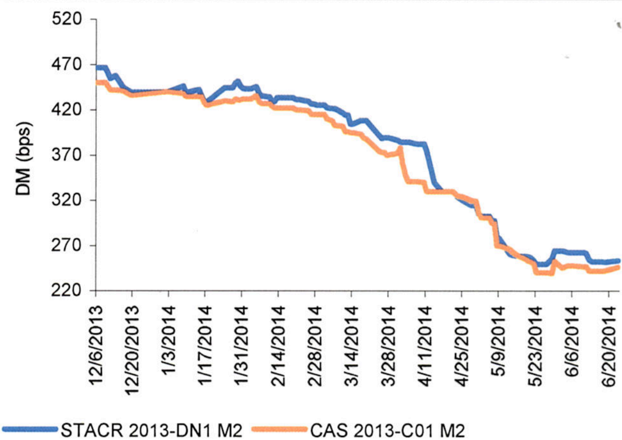
still strict compared to GN MBS which are Level 1 and therefore have no size restrictions or haircuts, but we believe if AAA non-agency MBS received liquidity status equal to or close to GSE MBS, it would help improve investor demand for PLS.

For insight into investor demand, appetite and comfort for PLS, RBS recommends looking the recent success of the GSE risk transfer deals[1]. Since 2013, there have been 8 deals totalling $8.2B in issuance. Though there was some hesitation from accounts on the first deal (which still saw participation from about 50 investors), the order books on subsequent deals have been many times oversubscribed as investors became comfortable with the underlying structure and credit. Furthermore, as the programs move toward benchmark status (with expected quarterly issuances), there has been and should continue to be even more interest. In secondary space, strong demand for these deals is evidenced by consistent spread tightening. For example: STACR 2013-DN1 M1s and M2s launched at L+340 and L+715 respectively and are now priced at L+69 and L+255 (as of 7/14/14). CAS 2013-C01 M1s and M2s launched at L+200 and L+525 respectively and are now priced at L+90 and L+256 (also as of 7/14/14). We show spread histories for these deals back to December 2013.

Spreads Steadily Tighten on first CRT Deals: M1 tranche
Source: RBS.



Spreads Steadily Tighten on first CRT Deals: M2 tranche
Source: RBS



Strong interest in these deals tells us two things: 1) investor appetite for credit is strong and 2) investors are comfortable taking GSE credit risk. That said, **RBS proposes that the FHFA look into setting up a GSE-linked master servicer to lure back private capital (from a capital markets standpoint).**

Bottom line: Once a lot of these issues are remedied, we can get a better estimate of what level PLS investors would be willing to enter the market and the level of g-fees that can influence that.

4.2 Regarding **depository institutions**, it is also difficult to pinpoint an accurate g-fee level that can determine whether depository institutions securitize or retain loans in portfolio. This decision to hold or securitize is also influenced by 1) market rates 2) regulatory requirements and 3) accounting issues. All of these factors are largely outside of FHFA's control. Because we have been in a low-rate environment for some time now, and also because of un-finalized, unclear and perhaps unfavourable regulatory requirements, depository institutions have started to reduce securitizations, instead holding or selling loan packages. Unlike securities, loans are not subject to mark-to-market requirements, therefore making them more appealing should interest rates rise (despite their fixed coupon).

We have recently seen banks increase the number of loans in portfolio relative to MBS, and also increase the number of deposits relative to loans. Because banks are willing to portfolio loans, Jumbo rates are very competitive with (athough no longer through) conforming rates (shown below right).The decreasing loan:deposit ratio (below, left) is the result of a recent influx of deposits and also increasingly conservative lender behavior. That said, we do not expect this relationship to continue indefinitely, as banks ideally want the ratio to be around 1:1.

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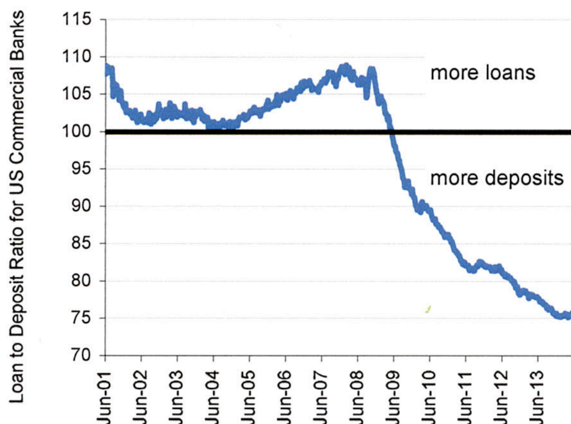
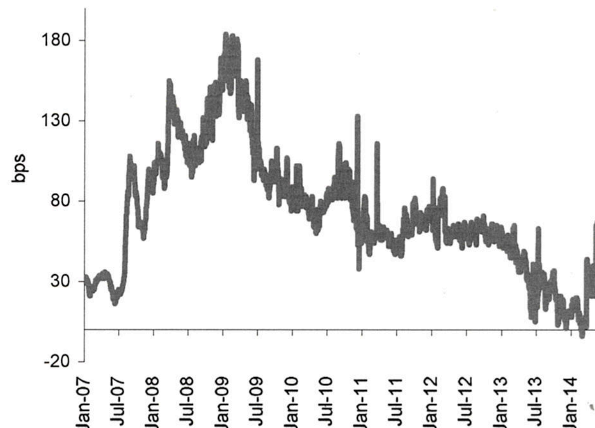
[1] We do acknowledge that using STACR and CAS deals are not a perfect substitute for PLS securities for a number of reasons. The debentures have GSE status for payment of both an uncapped LIBOR floater and 10 year final. They also have fixed severity rules, and a GSE first loss piece ahead of the risk-sharing bonds. For the more recent CAS deals that reference >80 LTV collateral, Fannie Mae (not the CAS investors) are exposed to the credit risk of the MI companies.

Loan to Deposit Ratio Continuously Bottoming
Source: RBS, Bloomberg.



Jumbo-Conforming Spreads Have Narrowed
Source: RBS, Bloomberg.



For lenders that do not want to hold loans on balance sheet, current market pricing still disfavors securitization. Loan packages currently trade at roughly 2.5 points behind TBA and most AAA bonds currently trade at 3.5 points behind TBA. With supply of non-agency mortgage exposure so light, investors are willing to pay up for loan packages in lieu of MBS, even though they may require more onerous due diligence and operations.

The bottom line here is that there is no absolute level of g-fees that will ensure an increase in PLS, especially in light of low rates, accounting treatment, and also regulations. All of these drawbacks currently outweigh the slightly better liquidity of AAA bonds. We maintain our general view that only until a lot of these issues are addressed will be see decent PLS growth.

4.3 As we do not believe there is an absolute g-fee level which can lure back PLS investors or promote bank retention, in light of all the other obstacles we discussed, we cannot compare one versus the other.

4.4 RBS believes that luring back private capital is important for a future housing finance system, in order to preserve borrower access to credit while the GSEs scale back. **That said, if g-fees were raised to a level higher than necessary to compensate taxpayers but able to lure back private capital, RBS would be supportive**. Having a greater backstop ahead of the GSEs would be largely beneficial to taxpayers as a whole. Also, borrowers faced with higher costs could potentially look to FHA loans in lieu of conventional loans if private label lending was not available or not an option. In other words, a rise in fees would not leave creditworthy borrowers with no (affordable) option.

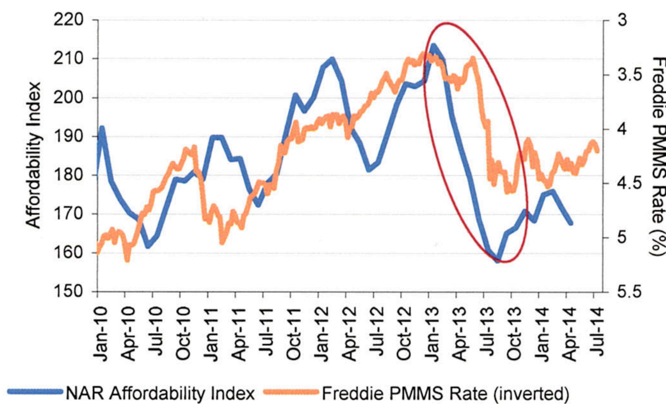
5. If the Enterprises continue to raise g-fees, will overall loan originations decrease? That is, will Enterprise loans decline without a commensurate increase in private capital?

Given the current high state of home affordability, the large premium price of Agency pass-throughs, and bank willingness to portfolio loans, **we think a small and gradual g-fee rise will probably not have a meaningful impact on overall loan originations**. It is possible, although a lot less likely, that given the high prices of securities in the secondary market, banks may not necessarily have to pass the g-fee increase on to the borrower. **That said, we do not think g-fees can be raised in perpetuity, especially given the current obstacles hindering private label market securitization, tight credit restrictions, and (as of late) the direct relationship between mortgage rates and home prices**. A large g-fee increase would most likely be passed on to the borrower and would result in a more expensive credit cost. We elaborate below.

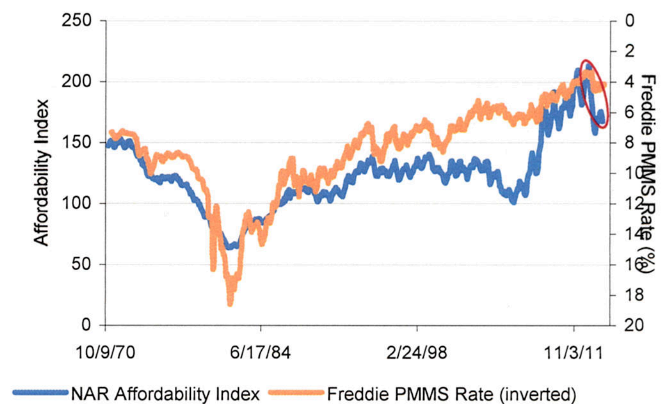
Factors Enabling Small G-fee Increase: If g-fees were to rise, lenders have three options: lenders pass the increase onto the borrower and securitize, lenders absorb the increase themselves and securitize, or lenders choose not to securitize (making g-fees irrelevant at the time of origination). Below we highlight some characteristics of the current market that make each of the above outcomes feasible, assuming g-fee increases are small.

- **High Home Affordability:** From May 2, 2013 through August 22, 2013, mortgage rates rose roughly 123 bps from the annual lows to the annual highs. The backup came after roughly 8 months of range bound rates, and a 20 month rally before that. Consequently the late 2013 backup made a dent in home affordability (chart below, left; we show mortgage rates on an inverted axis), bringing the NAR affordability index from the historic highs reached in January 2013, to levels last seen in summer 2010. However, on a long term basis, home affordability remains high in spite of rising home prices and a move to higher mortgage rates (chart below, right). As of the latest print (April 2014), The National Association of Realtors' Home Affordability Composite Index had a value of 167.8, which implied that the family with the median income had roughly 1.679 times the income to qualify for a median-priced home, assuming a 20% down payment and a 25% qualifying ratio. The data shown below indicates that 1) there is a strong correlation between rising rates and falling home affordability, but also that 2) there is ultimately some room for g-fees to rise, even if this meant higher rates for the borrower. The latter implies that g-fees can rise somewhat in the near term but the former indicates that a large enough increase could potentially push home prices into unaffordable territory.

2H 2013 Backup Caused A Drop in Home Affordability...
Source: National Association of Realtors, Bloomberg, RBS.



...But Home Affordability Still High on Long Term Basis
Source: National Association of Realtors, Bloomberg, RBS.



- **MBS Pass-throughs are Trading at a High Premium:** Given the high premiums mortgage pass-throughs currently trade at, a lender may not even need to pass the increase onto the borrower if the increase is small enough. If lenders are able and willing absorb the increase, there will likely be no impact to origination volumes. However, we find that at current rates, this strategy only makes sense for super prime borrowers. Most lenders are actually reporting tight margins due to rising origination costs and low mortgage rates.

  We help illustrate this point by showing simple securitization math below. At current levels, we estimate that lenders can securitize a 4.5% rate loan into a 4.0% pass-through and receive roughly 100.01 for prime and 100.76 for super prime collateral. (At current levels, it is not profitable to securitize barely prime loans at the current market rates). Should g-fees rise 25bps (here we assume the increase is in LLPAs), lender profitability on prime loans would go negative but super prime margins would remain positive (albeit drop to ~50bps). Large g-fee increases (e.g. 100bps) at current levels wipe out securitization profits entirely. Note that this analysis does not compare securitization versus retention and instead looks primarily on the impact of rising g-fees on securitization profit.

Securitization Options Under Different Borrower, LLPA Scenarios

Assumptions	
Coupon	4.375%
Duration	5.00
G-Fee Buy-Up	6.75
Servicing Multiple	4.00

Option 1. Current All-In Gfees

	Barely Prime 700 FICO, 90 LTV		Prime 720 FICO, 80 LTV		Super Prime 740 FICO, 60 LTV	
Cost of Origination		-2.50%		-2.50%		-2.50%
Servicing	0.25%	1.00%	0.25%	1.00%	0.25%	1.00%
LLPA		-1.00%		-0.50%		0.25%
G-Fee	0.60%		0.60%		0.60%	
Delivery Fee		-0.25%		-0.25%		-0.25%
Mortgage Insurance Premium	0.55%		0.00%	0.00%	0.00%	0.00%
Buy up/Buy down Coupon/Price	-1.03%	-6.92%	-0.48%	-3.21%	-0.48%	-3.21%
Pass-thru Coupon/Price	4.00%	105.47%	4.00%	105.47%	4.00%	105.47%
All in Price		**95.80%**		**100.01%**		**100.76%**

Option 2. 25bp Increase in All-In Gfees

	Barely Prime 700 FICO, 90 LTV		Prime 720 FICO, 80 LTV		Super Prime 740 FICO, 60 LTV	
Cost of Origination		-2.50%		-2.50%		-2.50%
Servicing	0.25%	1.00%	0.25%	1.00%	0.25%	1.00%
LLPA		-1.25%		-0.75%		0.00%
G-Fee	0.60%		0.60%		0.60%	
Delivery Fee		-0.25%		-0.25%		-0.25%
Mortgage Insurance Premium	0.55%		0.00%	0.00%	0.00%	0.00%
Buy up/Buy down Coupon/Price	-1.03%	-6.92%	-0.48%	-3.21%	-0.48%	-3.21%
Pass-thru Coupon/Price	4.00%	105.47%	4.00%	105.47%	4.00%	105.47%
All in Price		**95.55%**		**99.76%**		**100.51%**

Option 3. 100bp Increase in All-In Gfees

	Barely Prime 700 FICO, 90 LTV		Prime 720 FICO, 80 LTV		Super Prime 740 FICO, 60 LTV	
Cost of Origination		-2.50%		-2.50%		-2.50%
Servicing	0.25%	1.00%	0.25%	1.00%	0.25%	1.00%
LLPA		-2.00%		-1.50%		-0.75%
G-Fee	0.60%		0.60%		0.60%	
Delivery Fee		-0.25%		-0.25%		-0.25%
Mortgage Insurance Premium	0.55%		0.00%	0.00%	0.00%	0.00%
Buy up/Buy down Coupon/Price	-1.03%	-6.92%	-0.48%	-3.21%	-0.48%	-3.21%
Pass-thru Coupon/Price	4.00%	105.47%	4.00%	105.47%	4.00%	105.47%
All in Price		**94.80%**		**99.01%**		**99.76%**

Source: RBS. As of 7/7/14.

- **Banks Still Willing and Able to Portfolio Loans:** The fact that banks are currently willing and able to portfolio loans implies that near term g-fee increases may have a negligible effect on originations. This trend originally started with banks holding jumbo loans given the lack of a final QRM definition and higher capital restrictions (for PLS securities vs loans). Recent anecdotal evidence also shows that many large banks are keeping conforming (conventional) loans in their portfolios as well, likely due to aforementioned tight margins.

Factors Prohibiting a Large G-fee increase: If the rise in g-fees was substantial, we believe it would be passed on to the borrower. Given the current state of the mortgage finance market, the majority of borrowers are not left with that many affordable options outside of conventional lending. While banks are fine with retaining conforming loans in the near term, higher g-fees might make any eventual securitization unfeasible. That said, we do not believe g-fees can be raised in perpetuity for a handful of reasons:

- **QRM has not yet been finalized:** As a result, private label market securitization is essentially at a standstill. While banks are comfortable now holding loans, they likely cannot do this forever. Therefore, if g-fees get too high and banks cannot retain any more loans, banks may not be able extend credit if there is no PLS market.

- **Mortgage Credit is Limited**: Access to mortgage credit has been very strict ever since the post-crisis recovery began in late 2008 and new originations have been light largely as a result. A recent study done by the Urban Institute[2] attributes limited credit availability to a substantial drop in new purchase mortgage volume, even after factoring in lower home sales and an increased share of all-cash transactions. They conclude, comparing 2012 and 2000 origination volumes, that 2012 had somewhere between 273,000 and 1.2 million "missing loans" due to tight credit. That said, a measurable increase in g-fees will likely make it harder for borrowers to qualify, and in an already tight credit environment, this would have a further limiting effect on originations.

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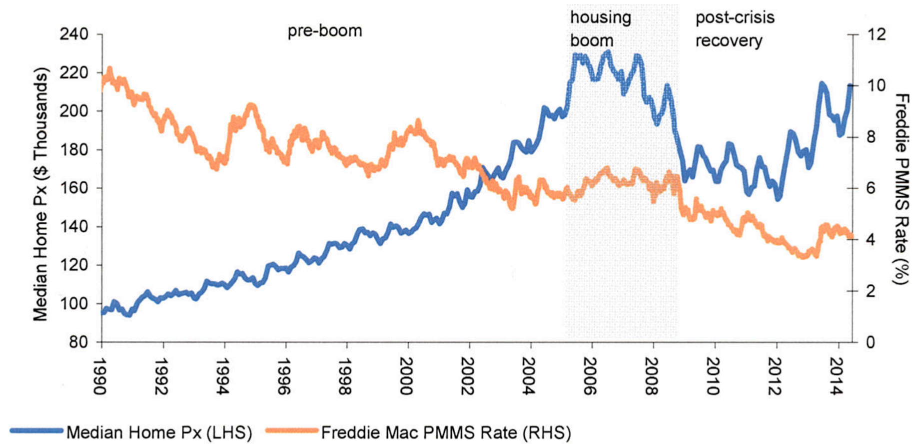
[2] The Urban Institute Publication "Where Have All the Loans Gone? The Impact of Credit Availability on Mortgage Volume" from March 2014 can be found here: http://www.urban.org/publications/413052.html

It is our view that perhaps current lending standards are too onerous. **RBS recommends the FHFA continue to clarify, and perhaps provide greater relief with respect to, representations and warranties such that lenders are not severely punished for trivial errors, but should continue to face repercussions on more critical underwriting issues such as fraud or misrepresentation**. We believe that if reps and warrants were clarified across the board, the PLS market could eventually be a responsible way to expand the borrower base outside of the absolutely pristine credits, and then subsequent g-fee increases may have more limited impacts on originations.

- **Direct Relationship Between Mortgage Rates and Home Prices**: We note that since the post crisis recovery began, mortgage rates and home prices have generally moved in the same direction. As a result, home affordability reached record highs as both rates and prices declined in Jan 2009 – Jan 2013. If this direct relationship continues, rising home prices compounded with rising mortgage rates should result in lower home affordability. We mentioned earlier that home affordability is high and there is probably some room to weather a g-fee increase; however <u>if a significant rise in g-fees was accompanied with a rise in base mortgage rates and home prices, home affordability is likely to decrease which could limit home purchase demand</u>.

Historical Mortgage Rates and Median Home Prices



Source: Bloomberg, RBS

The relationship that we see in the post-crisis environment is markedly different that what we saw in years prior. Leading up to the housing boom, home prices moved inversely with rates. Therefore an increase in home prices was partially offset with a drop in rates, lessening the impact to affordability. During the housing boom when credit standards were fairly lax, home prices increased while mortgage rates remained stable but down payments decreased. We show these patterns in the chart above. If the relationship reverts to one from the pre-crisis period, then rising g-fees may not have such a large impact on loan originations, especially if overall rising rates were reflective of a broader based economic recovery.

<u>Bottom line:</u> We continue to stress that there are numerous factors, most independent of rates and fees, that will impact origination volumes. In addition to those we described above, overall economic conditions (particularly job creation), lender capacity, homebuyer confidence, available inventory and cash (investor) purchases can all influence originations. Although the FHFA lacks the power to change these specific circumstances, **we do think that a large g-fee increase will impact originations assuming all other conditions are unchanged. However we believe that the market can withstand small, gradual increases, similar to what the FHFA has directed the GSEs to do over the past several years.**

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?

We believe it would be desirable and see no immediate issue if g-fee increases on lower credit score/higher LTV loans pushed risk-layered borrowers out of GSE loans to FHA in the near term. Therefore loans could be securitized via GNMA, instead of via FNMA or FHLMC. As long as credit worthy borrowers had a financing option, which in this case would be the FHA, we believe this could help the GSEs shrink their footprint. Shifting supply to FHA may not be the best long term solution, as we feel the PLS market is a better place for these loans. We elaborate on our views below.

Why shifting low credit score/high LTV loans to FHA may be desirable in the near term:

- While it is not explicitly stated, FHA has already become the de-facto source of credit for "first time homebuyers" due to low down payment requirements. For high LTV, Low FICO borrowers, the FHA market currently offers more attractive financing than does the conventional market. Unlike the GSEs, FHA does not differentiate pricing based on FICO. Like the GSEs FHA has different prices for different LTVs, but the FHA framework is a lot simpler with just a single LTV deciding fees. FHA annual mortgage insurance premiums ("MIPs") for a 30 year fixed loan less than or equal to $625,500 are either 130 bps for LTV less than or equal to 95% or 135bps for LTV greater than 95%[3].

  We show the pricing difference in the example below. For a 95 LTV borrower, FHA has a flat cost of credit (Mortgage Insurance Premium plus g-fee) of 1.76% annually. By contrast, a Fannie Mae loan has LLPAs and mortgage insurance fees that generally increase for higher FICOs. Additionally the base FHA mortgage rate is currently 1/8 point below the conventional rate. **Therefore, borrowers with 95 LTV and FICO <720 are already turning to the FHA market for better financing (table below).**

Cost of Credit: Conventional vs FHA for 95 LTV Loan (30yr Fix)

	LTV	FICO								
	95	≥760	740-759	720-739	700-719	680-699	660-679	640-659	620-639	<620
GSE	Gfee (ann)	0.450%	0.450%	0.450%	0.450%	0.450%	0.450%	0.450%	0.450%	0.450%
	ADMC (UF)	0.250%	0.250%	0.250%	0.250%	0.250%	0.250%	0.250%	0.250%	0.250%
	LLPA (UF)	0.250%	0.250%	0.500%	1.000%	1.250%	2.250%	2.750%	3.250%	3.250%
	All in Gfee (ann)	0.575%	0.575%	0.638%	0.763%	0.825%	1.075%	1.200%	1.325%	1.325%
	BP MI (30%, Ann)	0.590%	0.670%	0.670%	0.940%	0.940%	1.200%	1.200%	1.200%	1.200%
	All In Credit Costs (Ann)	1.165%	1.245%	1.308%	1.703%	1.765%	2.275%	2.400%	2.525%	2.525%
	Mortgage Rate	4.250%	4.250%	4.250%	4.250%	4.250%	4.250%	4.250%	4.250%	4.250%
	All In (Rate + Credit Costs)	5.415%	5.495%	5.558%	5.953%	6.015%	6.525%	6.650%	6.775%	6.775%
FHA	Gfee (ann)	0.060%	0.060%	0.060%	0.060%	0.060%	0.060%	0.060%	0.060%	0.060%
	MI (Initial, UF)	1.750%	1.750%	1.750%	1.750%	1.750%	1.750%	1.750%	1.750%	1.750%
	MI (Running, Ann)	1.300%	1.300%	1.300%	1.300%	1.300%	1.300%	1.300%	1.300%	1.300%
	Total MI (ann)	1.650%	1.650%	1.650%	1.650%	1.650%	1.650%	1.650%	1.650%	1.650%
	All In Credit Costs (Ann)	1.710%	1.710%	1.710%	1.710%	1.710%	1.710%	1.710%	1.710%	1.710%
	Mortgage Rate	4.125%	4.125%	4.125%	4.125%	4.125%	4.125%	4.125%	4.125%	4.125%
	All In (Rate + Credit Costs)	5.835%	5.835%	5.835%	5.835%	5.835%	5.835%	5.835%	5.835%	5.835%

Source: FHA, Fannie Mae, Radian, RBS. As of 7/9/14.

- FHA has not expressed any concerns over capacity constraints nor have they set any limits on the amount of loans they can insure. Instead their market share has been growing steadily since 2009.
- FHA loans are assumable. In an environment where turnover is steadily increasing and the long term trajectory for rates is higher, this option may prove very valuable.
- MBS Investors may benefit by an increase in GNMA MBS. GN MBS carries the explicit backing (full faith and credit) of the US Government. In the upcoming regulatory environment, GN MBS receive the most favorable capital (tier 1) and liquidity (level 1) treatment. Although the majority of banks must comply with these regulations, GNMA MBS supply has been light. Therefore, we believe that any increase in supply of GN MBS should be well received especially by bank portfolios.

[3] The 95 LTV turning point is for 30 year fixed rate loans. For 15 year FHA loans, annual MIPs are either 35bps for less than/equal to 90 LTV and 60bps for greater than 90 LTV. These numbers are for loan sizes less than or equal to $625,500 and exclude streamline refis where the original loan had a case number before 6/1/2009.

Why shifting low credit score/high LTV loans to FHA may be not be desirable in the long term:

- Shifting supply from the GSEs to FHA does not assist in stimulating the private label market and would likely keep the overall "government" footprint large. As a result, the risk to the government is unchanged, or one could even make the case that it has increased—as FHA loans have government-backed insurance, while most high LTV conventional loans have private mortgage insurance.
- These loans may not necessarily fall under the definition of Qualified Mortgage" ("QM. While QM does not specifically set limitations on FICO or LTV, these lower FICO/Higher LTV borrowers often have DTI ratios greater than 43%, which disqualifies the loans from earning QM status. Recall that effective Jan 10, 2014, all collateral in FN, FH, and GN MBS must meet the QM criteria. So while we think it makes sense for these loans to migrate out of the conventional space, we believe PLS execution (as opposed to GNMA execution) would be the most desirable outlet for these loans.

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 held on depository balance sheets, rather than guaranteed by the Enterprises?

RBS believes that increasing g-fees in general is one lever that can be used to lessen the GSE footprint, and in this case it may be desirable. A preliminary goal in GSE reform is to bring more private capital into the market. At the immediate time, the PLS market is more or less at a standstill, showing muted growth throughout the post crisis recovery. Even the momentum gained in 2013 seems to have stalled as issuers, investors, and other market participants await a final definition of QRM. That said, in the immediate term we believe it would be desirable to transfer some risk away from the GSEs, even if this meant loans that higher-credit loans migrated away from the GSEs and remain on depository balance sheets. In the long term however, we believe a PLS market would have to function, as depository institutions cannot retain loans on balance sheet forever. Raising g-fees is one mechanism to shift loans into private label space; but several other factors need to be remedied before that market is fully functional.

At first glance, dis-incentivizing the highest FICO/lowest LTV borrowers from conventional loans may seem counterintuitive as the net effect would be a GSE guaranty book of overall slightly lower credit quality. However, we note that this step would be helpful and possibly necessary in 1) ramping up private label lending and 2) ensuring the GSEs are the true credit provider for middle class borrowers.

If the FHFA is concerned that increasing g-fees for high credit score/low LTV loans may impair their overall book of business, we propose two ideas that may help mitigate:

1) Increase g-fees for higher credit score/lower LTV and lower credit score/higher LTV in tandem such that the former group shifts to the private label market and the latter to FHA, all else equal. GSEs will retain the mid-credit score/mid-LTV borrowers and the "average" credit quality of the book may see little change.

2) Explore charging g-fees based on loan balance, such that the larger loan sizes have higher upfront fees and the lower loan balances have smaller upfront fees. If a third dimension of loan balance was introduced into the upfront pricing grid, the FHFA may want to then instruct the GSEs to broaden the FICO buckets. We have seen in the past that LTV is a better predictor of borrower performance than FICO in stressed environments, and we think having granular definitions for three variables may be overcomplicated and unnecessary.

   We believe charging higher risk based premium on the larger loan balances could result in the following:

   a. **Larger loan balance borrowers may migrate to the PLS market**: We know that the FHFA is not looking to lower loan limits at this time. However, we believe one way of re-stimulating private label growth is via lower loan limits. We believe that charging higher fees at this corner of the credit box would likely have the same effect, as larger loan balance borrowers typically have strong credit. Furthermore while increasing g-fees here may steer higher balance borrowers into the PL market, it does not cut off their conventional access completely (as lowering loan limits might).

   b. **Borrowers would be incentivized to borrow only as much as they need**: Loan balance based g-fees should promote higher down payments and lower LTVs, consequently reducing some of the risk to the GSEs (and therefore taxpayers).