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September 8, 2014

Federal Housing Finance Agency
Office of Policy Analysis and Research
400 7th Street SW 9th Floor
Washington, DC 20024

Attention: Joe Prendergast, Manager of Policy and Research & Mortgage Insurance Eligibility Project

Re: Request for Input: Fannie Mae and Freddie Mac Guarantee Fees and Draft Revised Private Mortgage Insurer Eligibility Requirements

Dear Mr. Prendergast:

The Independent Community Bankers of America (ICBA) [1] appreciates the opportunity to provide comments regarding the structuring and impact of Guarantee Fees (gfees) and Loan Level Price Adjustments (LLPAs) from Fannie Mae and Freddie Mac (GSEs).

Community banks have long relied on the GSEs to provide access to the secondary mortgage market that allows community banks to originate and service mortgage loans in their communities without having to sell those loans to larger financial institutions which compete with them in selling financial and banking products to their customers. The GSEs have benefited enormously from doing business with community banks as loans originated and serviced by community banks tend to perform better over time when compared to loans originated by other lenders.

Community banks originate loans to the same high standards as loans that they retain in their portfolios. Unfortunately, those qualities have not always been recognized by the GSEs in the setting of pricing or contract terms. Frequently in the past, prior to the GSE Conservatorships, GSE contract terms and pricing (gfees) were based on volume of loans delivered to the GSEs rather than the quality of the loans being delivered. That practice has changed over the past five years and pricing terms appear to be more equitable.

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[1] *The Independent Community Bankers of America® (ICBA), the nation's voice for more than 6,500 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services.*
ICBA members operate 24,000 locations nationwide, employ 300,000 Americans and hold $1.3 trillion in assets, $1 trillion in deposits and $800 billion in loans to consumers, small businesses and the agricultural community. For more information, visit www.icba.org.

However, larger volume institutions still seem to get preferential treatment when it comes to credit variances or relief on repurchase requests. Fortunately, due to the high quality of loans delivered by community banks, the number of repurchase requests has not been that great. However, those community banks that did receive a repurchase request generally found they had little to no ability to convince the GSE to retain the loan, or negotiate a lower repurchase amount. In contrast, large national lenders were often able to achieve settlements involving thousands of defaulted loans for pennies on the dollar.

In spite of this poor treatment by the GSEs, community banks have continued to do business with the GSEs and continue to deliver high quality loans to the GSEs.
The FHFA has requested comment and feedback on twelve questions concerning the setting of GSE pricing (gfees and LLPAs) and the resulting impacts. ICBA will not provide specific answers for all twelve questions, but rather, provide our comments on the following points:

- **All loans sold to the GSEs should be fully risk-based priced;**
- **All lenders should see the same price for the same loan from the same GSE;**
- **GSE pricing should reflect the value of private mortgage insurance (MI);**
- **The GSEs must have some level of meaningful capital to support their business; and**
- **GSE pricing should not be used to restart the private label MBS market.**

Subsequent to this request, FHFA recently issued draft Primary Mortgage Insurance Eligibility Requirements (PMIERS), and has requested industry input and comment. FHFA recognizes that the PMIERs and its request for input on GSE guarantee fees are closely connected, and has requested commenters to submit comments on both proposals together. Thus, ICBA's comments on PMIERS are included in this letter as well. As FHFA has determined, it is critical to consider industry comments from both requests when developing a final approach to GSE pricing. The ability of the MI companies to provide effective first loss protection on a loan level basis that is affordable and dependable is critical to the GSEs carrying out their mission. At the same time, the GSEs and the MI companies must move away from arbitrarily rescinding MI coverage and forcing lender buy backs for minor violations when loans default. These actions create doubt that neither the GSEs nor the MIs can be reliable counterparties in the sharing of credit risk, and therefore lenders will continue to be overly conservative and keep access to credit extremely tight.

All loans sold to the GSEs should be fully risk-based priced.

Currently the GSEs use "average pricing" for the setting of base gfees which flows to all loan pricing. Average pricing means that the costs of capital, administrative fees, and default costs are spread (somewhat) equally over all loans the GSEs acquire regardless of the individual characteristics of the loans bought. To address various risk characteristics of a loan, the GSEs also charge Loan Level Price Adjustments (LLPAs) that help offset

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default costs. The benefits of average pricing are that default and capital costs are spread evenly across all loans, which tends to lower prices on lower quality loans (low FICO/high LTV) while making higher quality borrowers pay higher prices (high FICO/low LTV).

The problem with average pricing is that it invites adverse selection; meaning fees are raised on the higher credit quality borrowers to subsidize the lower quality borrowers, resulting in the higher quality business moving to other non-GSE products such as portfolio loans or private market products. The GSEs then end up with a mix of business that is higher risk, thereby driving higher credit costs, forcing them to continually raise fees to compensate.

Fully risk-based pricing each loan ensures that each loan is properly priced to reflect the credit risk that borrower represents. Fully risk-based pricing each loan also means giving full credit for the value of any credit enhancements on a particular loan such as mortgage insurance, or recourse. Currently the GSEs provide no reduction in their pricing for loans with MI, yet MI reduces the GSEs exposure considerably. (The treatment of mortgage insurance will be discussed further in this letter). In fact one could make the case that the GSEs over charge for higher LTV loans which have MI through the LLPA fees. This has the effect of driving the high LTV business to FHA.

The GSEs have devoted considerable resources to the development and refinement of their respect credit risk models used primarily for support of their automated underwriting engines and costing and pricing modeling. The move to utilize these resources to implement risk- based pricing of all loans would not be that difficult to implement and would address the adverse selection problem, eliminating the need for the LLPA grids. Loan level pricing could be delivered through the GSE automated underwriting systems at the time the loan is scored.

All lenders should see the same price for the same loan from the same GSE.

As stated earlier, the GSEs have made progress in removing the differences in pricing between lenders, in particular between large and small lenders. ICBA encourages the FHFA to ensure that pricing is uniform among all sellers to a particular GSE regardless of loan volume or market share from a particular lender and regardless of delivery channel to the GSE. Many times lenders delivering through the securitization paths of the GSEs have to ability to enhance their pricing through buy up and buy down grids which manipulates the excess servicing spreads of loans within a pool. This provides additional income to the lender giving them a price advantage over lenders who just deliver through the cash windows. All lenders should see the same price for the same loan from the same GSE.

GSE pricing should reflect the value of private mortgage insurance.

The GSEs are required to have a credit enhancement for any loan they purchase which has an LTV greater than 80 percent. Private mortgage insurance is the most common form of credit enhancement used by lenders to satisfy this requirement. Loss severity

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levels on over 80% LTV loans with MI are below those of uninsured loans in the over 60% up to 80% LTV bucket. Yet the GSEs give virtually no value to this credit enhancement in their current pricing. In fact, they charge higher LLPAs for higher LTV loans on top of receiving the benefit of the MI's first loss protection. This action by the GSEs unnecessarily drives up the cost on higher LTV loans, and contributes to making access to credit for lower down payment loans more difficult for credit worthy borrowers. Both GSEs and mortgage lenders have had the unfortunate experience of dealing with policy rescissions from MI companies on delinquent loans during the recent crisis, which triggered loan repurchase demands from the GSE to the lender. While some of these rescissions were justified, many were not, leaving both lenders and the GSEs to bear additional losses and creating uncertainty regarding the ability and willingness of a counter party to assume this first loss position. During the crisis, several MI companies went out of business, while others came close to becoming insolvent. However, those that did survive raised new capital and strengthened their risk management practices to become better and more reliable counter parties. With implementation of new stronger capital requirements along with changes to the MIs' master policies that provide both the lender and the GSEs with more certainty regarding the claims paying process, the value of mortgage insurance as a first loss guarantor should improve and the GSEs should adjust their pricing to reflect that value.

GSEs must have a meaningful level of capital to support their business.

Currently the GSEs are operating under conservatorship with very little capital to support and sustain their operations. As per the terms of the GSEs' preferred stock purchase agreements (PSPAs) with the U. S. Treasury, they cannot retain earnings to build capital. However, current GSE gfees assume a capital charge that ranges from 83 basis points in the lowest risk bucket to 712 basis points in the highest risk bucket[2]. The question is where does this capital go? It is not reflected on the GSEs' balance sheets, and there is no accounting for it at the FHFA. Rather it is swept directly into the U.S Treasury where its status is unknown. If the GSEs are including a charge for capital (which we believe is prudent), then there should be some type of accounting to show its disposition. If it is just treated as general revenue to the U.S. Treasury for deficit reduction, then it should not be charged.

To protect taxpayers and to prevent the need for future draws from the Treasury, ICBA strongly recommends the FHFA either amend the GSEs' PSPAs to allow them to rebuild capital or create a capital account held at FHFA that would be used to offset losses should they occur. ICBA further recommends that GSEs hold capital equivalent to what a FDIC-insured institution would be required to hold for mortgage loans on a balance sheet (4%-6.5%). Given the nature of the GSEs' public mission, duty to serve, and current operation under conservatorship, ICBA would recommend a lower targeted return on equity in the range of 4-5 percent. Guarantee fee pricing using those components would still provide an acceptable return to the GSEs while keeping mortgage credit affordable in the conventional conforming market.

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[2] *Figure 3 Credit and LTV Breakdown, 1st Quarter 2014; Federal Housing Finance Agency, Fannie Mae and Freddie Mac Guarantee Fees: Request for Input*

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ICBA firmly believes that the purpose of any financial regulator is to ensure the safety and soundness of the entities being regulated. In operating the GSEs without any meaningful capital, and preventing the GSEs from building needed capital, FHFA is putting taxpayers, the GSEs, and U.S. housing market at risk.

GSE pricing to should not be used to restart the private label MBS (PLMBS) market.

Since the collapse of the housing market in 2007 and 2008, mortgage loans sold to the GSEs have accounted for 70-80 percent of all conventional mortgage originations. This is far above the GSEs' traditional share of the mortgage market and reflects the lack of a robust private label MBS (PLMBS) market. During the period of 2009 to January 2014, FHFA, under the direction of Acting Director Ed DeMarco, pursued a strategy of attempting to shrink the GSEs' footprint in the marketplace by aggressively raising gfees and LLPAs. While some price increases were needed to help offset credit losses along with the 10 basis point fee increase to fund the Temporary Payroll Tax Cut Continuation Act of 2011 (TCCA), the focus of FHFA during this period was to raise gfees to a level that would put the GSE price execution level with a PLMBS execution. This would result in PLMBS investors and securitizers re-entering the market which would compete for loans with the GSEs. This strategy failed for several reasons. First, the PLMBS market's success was never really based on price execution, but rather it was based on a broader credit box than the GSE credit box. Second, with most of the PLMBS market dealing with massive defaults and losses due to poor underwriting, weak due diligence and fraud, investors were reluctant to purchase any PLMBS. In addition, the mortgage underwriting and servicing regulations, and the qualified residential mortgage regulations driven by the 2010 Dodd-Frank Wall Street Reform Act, have contributed to making the PLMBS market still a very small percentage of the overall mortgage market.

FHFA should continue to focus on its mission as conservator of the GSEs by overseeing their return to a strong financial and operational position, orderly reduction of their retained portfolios, and management and resolution of their defaulted loan portfolios. The GSEs should price their credit guaranty businesses appropriately as discussed earlier in this letter, and let the marketplace decide what the best execution is in terms of price, credit, and ease of delivery.

Comments on the Draft Private Mortgage Insurer Eligibility Requirements (PMIERs).

As mentioned above, ICBA appreciates the opportunity to provide comments on FHFA's draft Private Mortgage Insurer Eligibility Requirements (PMIERs or draft PMIERs). Private mortgage insurance provides critical first loss protection for the GSEs and mortgage lenders that is affordable and helps credit worthy borrowers buy homes with lower down payments. However, the GSEs and mortgage lenders need to be able to count on all Approved Insurers to be reliable counter parties, especially during times of economic stress. ICBA fully supports the FHFA goal that the draft PMIERs seeks to

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ensure, namely, that Approved Insurers have adequate liquidity and claims-paying capacity during periods of economic stress.

ICBA is concerned that certain provisions of the draft PMIERs may go beyond requiring "adequate liquidity and claims-paying capacity" and, as a result, could further constrain access to credit and/or increase the cost of homeownership for creditworthy borrowers.

Those provisions are:

- The draft PMIERs require MIs to hold an excessive amount of Available Assets (as defined in the draft PMIERs) especially on legacy books of business;
- Future contractual premiums are not includable as part of Available Assets; and
- The ability of the GSEs to make changes to the grid-based asset requirements with seemingly little warning or discussion creates a level of uncertainty for the MIs.

ICBA believes FHFA can modify the PMIERs to address all of the above without sacrificing strong counter party financial protections to the GSEs and the industry. Providing Approved Insurers with a defined process to change the grid-based asset requirements or make other changes to the PMIERs creates certainty that woulod allow the Approved Insurers to plan and manage their business. Allowing the Approved Insurers to count some portion of their contractual premiums towards the Available Assets requirements will help keep the cost of MI affordable and available for more credit worthy borrowers. As confidence in the MIs is restored, the GSEs should adjust their pricing, specifically the LLPA grids to reflect the value of the MIs first loss protection.

ICBA appreciates the opportunity to provide comments on both the Fannie Mae and Freddie Mac guarantee fee request for input and the draft PMIERs. ICBA looks forward to working with FHFA, the GSEs and the mortgage insurance industry to help rebuild a strong, dependable, liquid primary and secondary market that provides broad affordable access to credit for housing.

If you have any questions concerning this comment letter, please contact the undersigned at ron.haynie@icba.org.

Sincerely,

Ron Haynie
Senior Vice President-Mortgage Finance Policy
Independent Community Bankers of America