Federal Housing Finance Agency
Office of Inspector General

FHFA's Initiative to Reduce the Enterprises' Dominant Position in the Housing Finance System by Raising Gradually Their Guarantee Fees

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FHFA OIG

Synopsis

July 16, 2013

FHFA's Initiative to Reduce the Enterprises' Dominant Position in the Housing Finance System by Raising Gradually Their Guarantee Fees

Why OIG Did This Report

In 2012, Fannie Mae and Freddie Mac (the Enterprises) generated $12.5 billion in revenues from the single-family guarantee fees that they charge to protect investors in their mortgage-backed securities (MBS) against potential credit losses. The Federal Housing Finance Agency (FHFA or the Agency) has argued that federal financial support for the Enterprises over the years has permitted them to set their guarantee fees at artificially low levels, thereby increasing their risks and pricing potential competitors out of the market. As the Enterprises' conservator, FHFA has directed them to increase guarantee fees as a means to encourage greater private sector investment in mortgage credit risk, reduce their dominant position in housing finance, and limit potential taxpayer losses.

The Federal Housing Administration (FHA), an agency of the Department of Housing and Urban Development (HUD), insures mortgages originated by approved lenders against credit losses. FHA has raised its insurance premiums in recent years to, among other things, increase private sector investment in mortgage credit risk. In this respect, FHA's initiative is aligned in concept with that of FHFA. However, in the spring of 2013, HUD announced that FHA was discontinuing further premium increases.

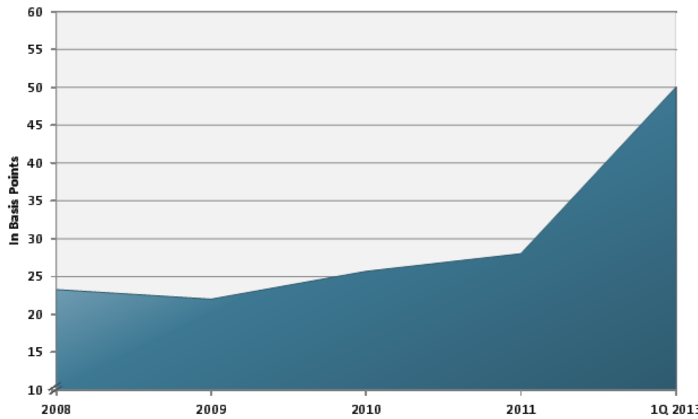
We conducted this evaluation to (1) analyze FHFA's initiative and (2) assess FHFA's communication and interactions with FHA on their pricing initiatives.

OIG's Analysis and Findings

FHFA's Initiative Faces Definitional and External Challenges

The Enterprises' average combined guarantee fees have nearly doubled since 2011 (see Figure, below). They rose in 2012 due to (1) legislation designed to offset temporary reductions in federal payroll taxes and (2) FHFA's initiative to increase private investment in mortgage credit risk. FHFA plans further Enterprise guarantee fee increases to spur private sector mortgage investment. However, it is not yet clear how high FHFA must increase guarantee fees to achieve its objectives, and, accordingly, the Agency will gradually raise fees given concerns about the potential impact on the housing finance system.

FIGURE. ESTIMATED ENTERPRISE AGGREGATED ANNUAL SINGLE-FAMILY GUARANTEE FEE PRICING: 2008–MARCH 31, 2013



Further, FHFA has not yet defined what it means by "increased private sector investment in mortgage credit risk" or developed measures thereof. The term could mean something as limited as a greater willingness on the part of lenders to hold mortgages in their portfolios rather than sell them to the Enterprises. Alternatively, it could mean something as far-reaching as a revival of the private-label mortgage-backed securities (PLMBS) market.

Additionally, trade-offs and challenges confront FHFA's initiative, including:

- Significant guarantee fee increases, under some scenarios, could result in higher mortgage borrowing costs and dampen both consumer demand for housing and private sector interest in mortgage credit risk; and
- Certain federal regulatory initiatives, while designed to combat abusive lending practices, could limit private sector incentives to invest in additional mortgage credit risk.

FHFA Should Seek to Establish a More Formalized Arrangement with FHA to Assess Key Issues

In 2011, HUD and the Department of Treasury issued a white paper on housing finance reform. It recommended that FHFA and FHA establish a formal working group to guide them in, among other things, raising guarantee fees and insurance premiums as means to reduce federal involvement in the housing finance system. FHFA has held meetings with FHA that have likely been beneficial, but the two agencies have not established a formal working group.

While we do not endorse the specifics of the white paper's recommendation, we believe that, in concept, FHFA may realize additional benefits by seeking to establish a more formal working relationship with FHA and jointly assessing the key issues that may affect their pricing initiatives. For example, the agencies could assess the potential implications of HUD's recent decision to halt further FHA premium increases even as FHFA continues to raise Enterprise guarantee fees. The potential exists that a resulting pricing disparity between guarantee fees and insurance premiums could shift a portion of the Enterprises' mortgage business and its

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associated risks to FHA's market without an overall increase in private sector investment in mortgage credit risk.

What OIG Recommends

We recommend that FHFA establish definitions and performance measures for its initiative to raise Enterprise guarantee fees as a means to increase private investment. We also recommend that FHFA assess the feasibility of establishing a formal working arrangement with FHA to assess critical issues involving their pricing initiatives.

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ABBREVIATIONS

CFPB	Consumer Financial Protection Bureau
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
Fannie Mae	Federal National Mortgage Association
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FHFOB	Federal Housing Finance Oversight Board
Freddie Mac	Federal Home Loan Mortgage Corporation
FSOC	Financial Stability Oversight Council
GAO	U.S. Government Accountability Office
Ginnie Mae	Government National Mortgage Association
GPRA	Government Performance and Results Act of 1993
HUD	U.S. Department of Housing and Urban Development
LTV	Loan-to-Value Ratio
MBS	Mortgage-Backed Security
OIG	Federal Housing Finance Agency Office of Inspector General
PLMBS	Private-Label Mortgage-Backed Security
RD	U.S. Department of Agriculture Rural Development
Treasury	U.S. Department of the Treasury
VA	U.S. Department of Veterans Affairs

PREFACE

In 2012, the Enterprises generated $12.5 billion in net revenues from their single-family MBS guarantee fees.[1] In exchange for the fees, the Enterprises guarantee that their investors will continue to receive timely principal and interest payments on their MBS regardless of the performance of, or credit risk associated with, the mortgages underlying the securities.[2]

During the housing boom of 2004 through 2007, the Enterprises purchased increasingly risky mortgage assets that were securitized into MBS and sold to investors. However, the Enterprises underestimated the credit risks associated with these mortgages and set their guarantee fees at levels that were too low to mitigate the risks. According to FHFA officials, the federal government's financial support for the Enterprises over the years permitted them to charge artificially low guarantee fees that, in turn, increased their risks and provided them with a significant competitive advantage over their potential private sector competitors. Consequently, when the housing boom ended, the Enterprises suffered billions of dollars in credit losses on their MBS guarantees. These losses are a principal reason that the Enterprises entered into conservatorships overseen by FHFA in September 2008.

In 2012, FHFA directed the Enterprises to increase their guarantee fees, and the Agency intends to direct further but gradual guarantee fee increases to achieve several objectives.[3] FHFA officials said raising the Enterprises' guarantee fees on a gradual basis will: (1) cause an increase in private sector investment in mortgage credit risk; (2) reduce the Enterprises' currently dominant position in the secondary mortgage market; and (3) conserve Enterprise assets and reduce (over time) the risk to the taxpayer caused by the

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[1] This report focuses on the Enterprises' guarantee fees for their single-family mortgage line of business, which generated $12.5 billion in net revenue in 2012. It excludes guarantee fees from the Enterprises' much smaller multifamily mortgage business, which generated net revenue of $1.2 billion for the Enterprises in 2012.

[2] Credit risk is the risk that borrowers will default on the mortgages that serve as the collateral for the Enterprises' MBS.

[3] FHFA's specific goal is to "contract" the Enterprises' operations and diminish their dominant presence in the marketplace through guarantee fee increases and other means. FHFA believes that increases in the Enterprises' guarantee fees will cause them to resemble more closely the pricing structure that would occur in a purely private marketplace. This, in turn, would render it more likely that private sector investment in mortgage credit risk would increase from present levels. *See*, *e.g.*, FHFA, *A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending*, at 14-17 (February 21, 2012) (online at http://www.fhfa.gov/webfiles/23344/StrategicPlanConservatorshipsFINAL.pdf); FHFA, *Statement of FHFA Acting Director Edward J. DeMarco before the American Mortgage Conference, The Conservatorships of Fannie Mae and Freddie Mac: An Update on Current and Future Operations* (September 10, 2012) (online at http://www.fhfa.gov/webfiles/24365/2012DeMarcoNCSpeechFinal.pdf); and FHFA, *Annual Performance Plan for Fiscal Year 2013*, at 33-34 (October 24, 2012) (online at http://www.fhfa.gov/webfiles/24624/FinalFHFAFY2013APP102412.pdf).

Enterprises' market activities.[4] Further, FHFA believes that contracting the Enterprises' market presence by these means is consistent with Congressional and Administration efforts to reform the housing finance system.[5]

Similarly, FHA provides mortgage insurance to protect approved lenders from credit risk. In recent years, FHA has increased its mortgage insurance premiums in order to improve its financial condition and reduce federal support for the housing finance system.[6] However, in April 2013, HUD announced the cessation of further mortgage premium increases because—in FHA's view—the increases to date have been sufficient to improve FHA's financial soundness and additional increases may harm the housing recovery.[7]

The FHFA Office of Inspector General (OIG) initiated this evaluation to (1) provide an independent analysis of FHFA's initiative to increase private sector investment in mortgage credit risk and reduce the Enterprises' dominant position in housing finance through gradual increases in their guarantee fees and (2) assess FHFA's communication and interaction with FHA on their pricing initiatives.[8]

This evaluation report was prepared by Simon Z. Wu, Chief Economist; Wesley M. Phillips, Senior Policy Advisor; Alan Rhinesmith, Senior Financial Advisor; Jon Anders, Program Analyst; Omolola Anderson, Senior Statistician; and Brian Harris, Investigative Counsel. OIG appreciates the cooperation of all those who contributed to this effort.

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[4] As discussed in this report, secondary market participants, such as the Enterprises, purchase mortgages from primary lenders and generally package them into MBS that are sold to investors.

[5] For example, in February 2011, HUD and the Department of Treasury issued a report that identified options for housing finance reform, all of which called for the termination of the Enterprises in their current form. *See,* Treasury and HUD, *Reforming America's Housing Finance Market: A Report to Congress* (February 2011) (online at http://www.treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf). *See also* OIG, *Semiannual Report to the Congress: October 1, 2012, through March 31, 2013*, Section 3 "Enterprise Reform" (online at http://www.fhfaoig.gov//Content/Files/EnterpriseReform.pdf).

[6] For more information on FHA's mortgage premium increases and their objectives, including reducing FHA's involvement in the housing finance system, *see* HUD, *Mortgagee Letter 2013-04* (January 31, 2013) (online at http://portal.hud.gov/hudportal/documents/huddoc?id=13-04ml.pdf); and Carol J. Galante, *Letter to Senator Bob Corker* (December 18, 2012) (online at http://www.corker.senate.gov/public/index.cfm/2012/12/after-securing-a-commitment-to-make-substantial-fha-reforms-corker-says-he-will-support-galante-for-fha-commissioner).

[7] *See*, Senate Appropriations Subcommittee on Transportation, Housing and Urban Development, and Related Agencies, *Hearing on President Obama's Fiscal 2014 Budget Proposal for the Housing and Urban Development Department*, Question and Answer Session, 113th Cong. (April 11, 2013); and HUD, *Statement of Secretary Shaun Donovan before the Mortgage Bankers Association National Advocacy Conference* (April 24, 2013).

[8] OIG notes that FHFA has other initiatives to encourage private sector investment in mortgage credit risk, such as a risk sharing initiative, which is discussed briefly in Appendix B. These initiatives were outside the scope of this evaluation report.

This evaluation report has been distributed to Congress, the Office of Management and Budget, and others, and will be posted on OIG's website, www.fhfaoig.gov.

Richard Parker
Director, Office of Policy, Oversight, and Review

DISCUSSION AND ANALYSIS...

This section of the report contains a brief overview of the U.S. housing finance system—the context within which FHFA's decision to raise the Enterprises' guarantee fees will take place. The overview is followed by analyses of the manner in which the Enterprises set their guarantee fees, fluctuations in guarantee fees over time, and the trade-offs and challenges that may await FHFA's effort to reduce the Enterprises' dominant position in the housing finance system by increasing their guarantee fees.

Overview of the Structure of the U.S. Housing Finance System

The housing finance system is comprised of the primary and secondary mortgage markets. The primary market consists of banks, thrifts, credit unions, and other financial institutions that deal directly with borrowers in the origination of home mortgage loans. These institutions originate a variety of mortgages, including conforming mortgages, i.e., those that meet the Enterprises' underwriting standards. Primary market institutions can also originate non-conforming mortgages, i.e., those that do not meet the Enterprises' underwriting standards, as well as mortgages that exceed the conforming loan limit. Finally, primary market institutions also originate mortgages that are insured by FHA or guaranteed by the U.S. Department of Veterans Affairs (VA) or the U.S. Department of Agriculture Rural Development (RD).[9]

Primary market institutions typically sell the mortgages they originate to participants in the secondary market, such as the Enterprises. Doing so enables the primary lenders to obtain financial liquidity that they can use to originate additional mortgages. Historically, secondary market participants have packaged the mortgages they purchase into MBS or PLMBS that they sell to investors.[10] However, since the advent of the financial crisis in 2008 and the collapse of the PLMBS market, the Enterprises' MBS and MBS guaranteed by the Government National Mortgage Association (Ginnie Mae) have comprised virtually all MBS issuances.[11]

Figure 1, below, illustrates the primary and secondary mortgage markets.

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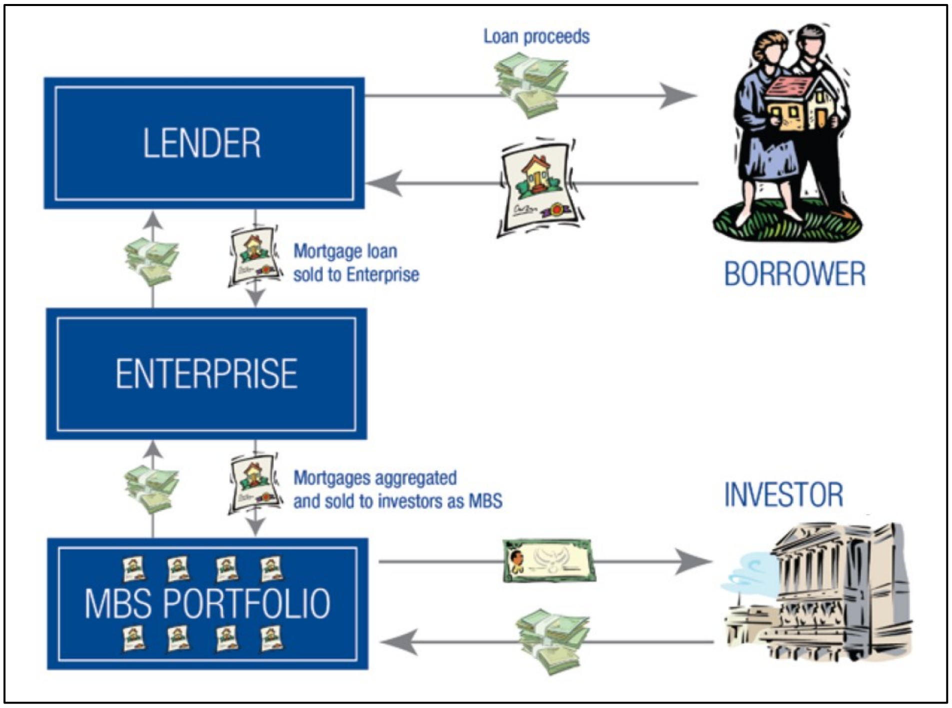
[9] For a discussion of non-conforming mortgage loans, *see* GAO, *Housing Enterprises: Potential Impacts of Severing Government Sponsorship* (GAO/GGD-96-120) (May 1996) (online at http://www.gao.gov/assets/160/155442.pdf).

[10] The mortgages that comprise PLMBS securitizations generally do not meet the Enterprises' underwriting standards as described in this evaluation report.

[11] Ginnie Mae guarantees MBS collateralized by government insured or guaranteed mortgages.

FIGURE 1. MORTGAGE ORIGINATION AND SECURITIZATION PROCESS



Conforming Mortgage Markets

Conforming mortgages are those that meet the Enterprises' underwriting standards and do not exceed the conforming loan limits established by statute and regulation. The Enterprises' mortgage underwriting standards are comprised of, among other things, loan-to-value (LTV) requirements, minimum credit scores, and debt-to-income standards.[12] For 2013, the conforming loan limit for single-family mortgages is $417,000 for most areas of the contiguous United States, although it can increase to a maximum of $625,500 in specific higher cost areas.[13]

The Enterprises typically securitize the loans they purchase by aggregating or pooling them into MBS, which are then sold to investors. As part of the securitization process, and to reduce investors' risks, the Enterprises ensure the timely payment of principal and interest

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[12] For 2012, Fannie Mae required a minimum credit score of 660 for loans with LTVs above 75% and a debt-to-income ratio of 36% to 45% depending on compensating factors. Freddie Mac's underwriting standards are similar. *See* OIG, *FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards* (AUD-2012-003) (March 22, 2012) (online at http://fhfaoig.gov/Content/Files/AUD-2012-003_1.pdf); Freddie Mac, *Single-Family Seller/Servicer Guide, Exhibit 25: Mortgages with Risk Class and/or Minimum Indicator Score Requirements* (May 15, 2013); and Freddie Mac, *Single-Family Seller/Servicer Guide, Chapter 37.16: Monthly debt payment-to-income ratio* (August 16, 2010).

[13] *See* FHFA, *Conforming Loan Limit* (online at http://www.fhfa.gov/Default.aspx?Page=185).

on their MBS in exchange for the payment of a guarantee fee.[14] Alternatively, the Enterprises may hold these loans or purchase MBS for their own investment portfolios.

Non-Conforming Mortgage Markets

Historically, the non-conforming mortgage market included loans that were inconsistent with the Enterprises' underwriting standards or exceeded the established conforming loan limits.[15] For example, non-conforming loans, which can include subprime loans, may have been made to borrowers whose credit scores do not meet the Enterprises' underwriting standards. Such loans cannot be sold to an Enterprise.

Although lenders generally cannot sell non-conforming mortgage loans to the Enterprises there has been a secondary market for them. Originators could sell them to financial intermediaries that would package them into securities known as PLMBS. However, as described previously, the secondary market for non-conforming loans and, thus, PLMBS, has largely disappeared since the financial crisis in 2008.[16]

Government Insured and Guaranteed Mortgage Markets

Primary market lenders may also originate mortgages that are insured or guaranteed by the federal government, including:

- FHA-insured mortgages – FHA provides single-family mortgage programs that insure approved private lenders against losses from borrower defaults on mortgages that meet FHA criteria. Borrowers pay premiums to FHA that are used to compensate lenders for losses associated with borrower defaults or foreclosures.
- VA-guaranteed mortgages –VA provides lenders a guaranty against losses on a portion of the principal balance on loans made to eligible veterans, active duty service members, surviving spouses, and members of the reserve components.
- RD-guaranteed loans – RD provides lenders a guarantee against losses on mortgage loans provided to low- and moderate-income borrowers in rural areas.

Ginnie Mae, which operates as a unit of HUD, provides a secondary market for government insured or guaranteed loans. Ginnie Mae provides an explicit guarantee (the full faith and

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[14] As discussed in this report, lenders that sell mortgages to the Enterprises generally pay guarantee fees to them. However, the associated costs of guarantee fees are generally passed on to mortgage borrowers as higher mortgage interest rate costs.

[15] Mortgages with balances above the established conforming loan limits are known as "jumbo mortgages." Jumbo mortgages may conform to Enterprise underwriting standards under certain circumstances.

[16] OIG observes that in 2012 and 2013 there have been several securitizations of jumbo mortgages.

credit of the United States) on MBS that is collateralized by FHA, VA, or RD mortgages. However, unlike the Enterprises, Ginnie Mae does not issue its own MBS. Rather, it relies upon approved financial institutions to pool and securitize the eligible mortgages and issue Ginnie Mae-guaranteed MBS. Ginnie Mae's guarantee is limited to the risk that issuers may not fulfill the required monthly principal and interest payments to investors.[17] For this guarantee Ginnie Mae charges MBS issuers a guarantee fee.[18]

The Enterprises and Ginnie Mae Have Dominated MBS Issuances Since the Collapse of the PLMBS Market

Figure 2 provides historical information on MBS issuances, a key measure of secondary mortgage market activities, and illustrates the growing dominance of the Enterprises and Ginnie Mae since the housing crisis began in 2008. During the 1990s, Enterprise MBS on average accounted for slightly more than 60% of all MBS issuances, Ginnie Mae about 20%, and PLMBS issuances about 20%. By 2003, the Enterprises' market share had increased to nearly 70%. However, there was a dramatic market shift toward PLMBS issuances and away from Enterprise MBS during the housing boom years of 2004 through 2007. In 2006, for example, PLMBS issuances accounted for about 56% of the market, the Enterprises about 40%, and Ginnie Mae just 4%. Since the collapse of the PLMBS market in 2008, Enterprise and Ginnie Mae MBS issuances have accounted for nearly all new MBS issuances with their market share reaching nearly 100% in 2012.[19]

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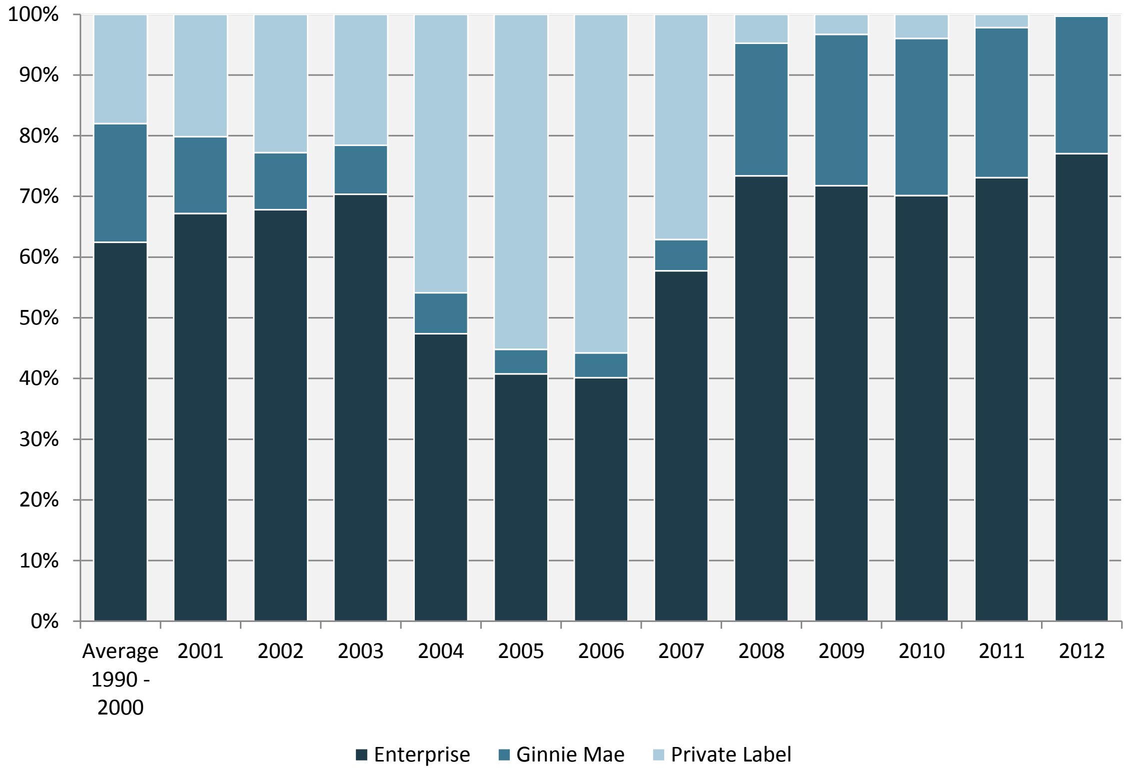
[17] Generally, Ginnie Mae takes control of MBS issuances for which private sector issuers cannot guarantee the timely payment of principal and interest by committing their own funds. FHA, VA, and RD are ultimately responsible for providing financial protection to lenders for the costs associated with the credit defaults on the mortgage collateral underlying the Ginnie Mae MBS issuances.

[18] *See* GAO, *Ginnie Mae: Risk Management and Cost Modeling Require Continuing Attention* (GAO-12-49) (November 2011) (online at http://www.gao.gov/assets/590/586247.pdf).

[19] The Enterprises have been able to continue their operations because of the support provided to them by the federal government.

FIGURE 2. MARKET SHARE OF MORTGAGE-BACKED SECURITIES ISSUANCES. 1990-2012[20]



FHFA has directed the Enterprises to raise their guarantee fees as a means to reduce their dominance in the MBS market and encourage greater private sector competition and assumption of mortgage risks. In recent years, FHA has pursued a similar strategy. Specifically, it sought to ensure the financial soundness of its mortgage insurance fund by raising its insurance premiums and tightening its underwriting standards.[21] FHA has stated that these increases were also intended to encourage greater private sector investment in mortgage credit risk.[22] OIG notes that HUD recently halted these premium increases because it believes the increases to date have improved FHA's finances.[23, 24]

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[20] Source: FHFA Office of Financial Analysis and Inside Mortgage Finance.

[21] *See*, GAO, *Overview of GAO's Past Work on FHA's Single-Family Mortgage Insurance Programs* (GAO-13-400R) (March 7, 2013) (online at http://www.gao.gov/assets/660/652829.pdf).

[22] Carol J. Galante, *Letter to Senator Bob Corker* (December 18, 2012) (online at http://www.corker.senate.gov/public/index.cfm/2012/12/after-securing-a-commitment-to-make-substantial-fha-reforms-corker-says-he-will-support-galante-for-fha-commissioner).

[23] *See*, Senate Appropriations Subcommittee on Transportation, Housing and Urban Development, and Related Agencies, *Hearing on President Obama's Fiscal 2014 Budget Proposal for the Housing and Urban Development Department*, 113th Cong. (April 11, 2013).

Overview of the Enterprises' General Processes for Structuring and Setting Guarantee Fees

This section explains what Enterprise guarantee fees are, provides an overview of the processes by which the Enterprises structure their guarantee fees, and discusses how guarantee fee levels are established generally.[25] Additionally, it discusses the provision of federal financial support to the Enterprises, and how FHFA believes this support has permitted them to set their guarantee fees lower than might otherwise have been the case.

What are Enterprise Guarantee Fees

By providing guarantees on their MBS, the Enterprises assure investors that they will receive the timely payment of principal and interest on their securities. While such investor guarantees have likely contributed to the development of the secondary market for conforming loans, they also expose the Enterprises to the risk that some homeowners will default on the mortgage securities that collateralize the MBS. Consequently, the Enterprises face significant credit risks associated with their MBS guarantees to investors, and they charge guarantee fees to cover the potential credit costs associated with meeting their obligations to MBS investors and other things as described below.

How Enterprise Guarantee Fees Are Structured and Collected

In general, Enterprise guarantee fee rates are a fraction of a percentage of the outstanding principal balance of a particular MBS issuance. Typically, these fractions are referred to as basis points, i.e., 1/100 of 1% of the unpaid principal balance. Suppose, for example, that an Enterprise issued an MBS security with an average unpaid principal balance of $100

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[24] OIG notes that while FHA has halted further increases to its mortgage insurance premiums, it has recently implemented a policy that ceases its prior practice of cancelling mortgage insurance premium payments after five years, or when loans' outstanding principal balance reached less than 78% of the original loan amount. As of June 3, 2013, mortgage insurance premiums are collected on the unpaid principal balance of FHA loans with an LTV of greater than 90 for the entire period in which they are insured. *See,* HUD, *Mortgagee Letter 2013-04* (January 31, 2013) (online at http://portal.hud.gov/hudportal/documents/huddoc?id=13-04ml.pdf) and Senate Committee on Appropriations, Subcommittee on Transportation, Housing and Urban Development, and Related Agencies, *Written Testimony of Carol Galante, Assistant Secretary for Housing/Federal Housing Administration Commissioner, U.S. Department of Housing and Urban Development, Federal Housing Administration's Fiscal Year 2014 Budget Request*, at 5 (June 4, 2013) (online at http://www.appropriations.senate.gov/ht-transportation.cfm?method=hearings.download&id=515e5e3a-2a31-46bd-b039-67a3bdc9b883).

[25] For a more detailed discussion of the Enterprises' process for setting guarantee fees, *see* FHFA, *Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2010 and 2011* (August 2012) (online at http://www.fhfa.gov/webfiles/24258/Gfeestudy2011_83112.pdf) (hereinafter "*FHFA Guarantee Fee Study*").

million. Thus, if the guarantee fee rate was 33 basis points (or 33/100s of 1%), then the upfront guarantee fees collected for the MBS would be $330,000.[26]

As set forth below, the Enterprises use two general approaches to collect upfront guarantee fees:

- When doing business with large lenders, the Enterprises usually employ swap programs. Under them, the Enterprises obtain whole mortgage loans, securitize them into MBS, and then sell/swap the MBS back to the original lenders.[27] Lenders who participate in these swap programs (or delegated mortgage servicers) pay guarantee fees directly to the Enterprise on the MBS that they obtain.
- Alternatively—particularly when dealing with smaller lenders—the Enterprises pay cash for mortgages, securitize them, and sell the resulting MBS to other investors, such as commercial banks and pension funds. Selling lenders effectively pay the guarantee fees—at the time of sale—in the form of lower proceeds from the Enterprise for the loan sold.

According to FHFA, larger lenders traditionally received guarantee fee discounts based upon the volume of business that they conducted with the Enterprises. Thus, larger lenders tended to pay lower guarantee fees on the MBS they received through the swap programs than the effective guarantee fees paid by smaller lenders on their sales of whole mortgage loans to the Enterprises.

In effect, the higher guarantee fees paid by smaller lenders have covered, to some degree, the potential credit losses suffered by the Enterprises on MBS collateralized by larger lenders. This is known as cross-subsidization. Appendix A contains a detailed discussion of cross-subsidization as well as FHFA's initiatives to minimize it through revisions to the Enterprises' guarantee fee structures.

In addition to upfront guarantee fees, the Enterprises collect ongoing guarantee fees on the principal balance of their outstanding MBS. The ongoing fees reduce the yield investors receive on the MBS. For example, if the effective interest rate on a pool of loans underlying the MBS is 3.75%, and the MBS carries a 50 basis point ongoing guarantee fee and a 25 basis point servicing fee, then the investor's rate of return on the MBS would be 3%.

[26] Guarantee fees are generally assessed as ongoing monthly payments; however, they frequently include upfront fees that are paid at the time of loan acquisition. The estimated total guarantee fees shown in this report represent the sum of the underlying loans' ongoing fees and the annualized equivalent of any upfront fee. For more information on this methodology, see *FHFA Guarantee Fee Study* at 4 and 14.

[27] Officials from one Enterprise said large lenders typically sell the MBS to other investors.

The Enterprises Employ Financial Models in Setting MBS Guarantee Fees

Each Enterprise uses proprietary financial models to help establish the price at which to set guarantee fees to cover the credit risks and other potential costs associated with a particular MBS issuance. As explained by FHFA in a 2012 analysis of Enterprise guarantee fees:

> Fannie Mae and Freddie Mac consider many factors in determining guarantee fees they charge, including the estimated cost of guaranteeing specific mortgages, competitive conditions in the market for bearing mortgage credit risk, regulatory requirements, the relative pricing of each Enterprise's MBS, the Enterprises' public mission, and return on capital targets. No set formula exists for weighing these factors. Instead, each Enterprise weighs them differently and works toward its view of a balanced outcome in line with market conditions and company goals.[28]

To ascertain the credit risk associated with a particular issuance, an Enterprise will attempt to model, among other things, the rate at which the underlying mortgages will default (the mortgage default rate) and the average losses on those that default (the loss severity rate).

The mortgage default rate is a probability measure, and it is based upon particular loan characteristics, such as credit scores and LTVs, as well as macroeconomic variables, including home price and interest rate projections. The loss severity associated with a particular MBS issuance is an estimate of the loss that will be caused by mortgage defaults in the underlying pool over the life of the issuance. For example, a loss severity rate of 30% on defaulted mortgages with an unpaid principal balance of $1,000,000 would equate to a loss of $300,000.

If an Enterprise can reliably model the default and loss severity rates associated with a particular MBS issuance, then it can estimate the credit risk associated with the issuance and set an appropriate guarantee fee.

The Enterprises also employ their financial models to ensure that revenues generated by their guarantee fees are sufficient to cover their capital costs,[29] administrative costs,[30] and certain other items.[31]

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[28] *See FHFA Guarantee Fee Study,* at 5.

[29] The cost of capital is determined by the Enterprises' targeted rate of return on capital (or profitability) and the level of capital required to support the mortgage. To estimate the cost of capital, the models simulate the risk-based costs of guaranteeing loans. Each Enterprise has begun to revise the risk-based capital framework by which it will conduct its single-family MBS business. Under the new frameworks, the Enterprises will align their capital standards more closely with those of private financial institutions when setting their

The Enterprises Also Rely Upon Business Judgment in Setting Guarantee Fees

Enterprise officials said that, in addition to their financial models, they rely upon business judgment to set guarantee fee rates. The factors that might be considered include assessments of competitive market conditions, return on capital targets, and mission/affordable housing goals. Moreover, Freddie Mac officials said that they have traditionally considered the financial markets' view that Fannie Mae's MBS issuances offer superior liquidity to investors. As a result, Freddie Mac has attempted to provide financial incentives—through its guarantee fee pricing structure (i.e., lower fees)—for lenders to sell mortgages to it.[32]

The Impact of Federal Financial Support on Guarantee Fees

Although Fannie Mae and Freddie Mac have used financial model outputs and business judgment to set guarantee fees, FHFA and others have argued that federal financial support for the Enterprises has allowed them to set their guarantee fees lower than would otherwise have been the case.

Prior to the establishment of the conservatorships in 2008, the Enterprises long benefitted from financial markets' perception that their obligations were backed by an implicit federal guarantee.[33] That is, to enable the Enterprises to meet their obligations, the federal government would provide to them financial support, such as making good on their guarantee to make timely principal and interest payments to their MBS investors. As a result, the Enterprises were generally able to fund their operations by issuing debt at levels only slightly higher than those charged by the U.S. Treasury on its securities with similar maturities. Since 2008, the Enterprises have generally continued to issue debt at favorable rates due to Treasury's direct financial support for them during their conservatorships.

FHFA officials told OIG staff that the debt-issuance funding advantage that the Enterprises enjoy as a result of federal financial support represents a subsidy that allows them to price

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guarantee fees through internal modeling. Essentially, the Enterprises would raise their capital costs, which, in turn, would cause them to raise their guarantee fees.

[30] Administrative costs are also known as G&A expenses.

[31] Other items, such as net float income or expense, are derived from the models and based primarily on contractually specified payment requirements.

[32] Between 2000 and 2008, Freddie Mac's estimated annual guarantee fee was set on average 2.7 basis points below that of Fannie Mae.

[33] For further discussion of the implicit guarantee, *see* OIG, *FHFA's Oversight of Troubled Federal Home Loan Banks*, at 6 (EVL-2012-001) (January 11, 2012) (online at http://fhfaoig.gov/Content/Files/Troubled%20Banks%20EVL-2012-001.pdf).

their products and services, including their MBS guarantee fees, at rates lower than otherwise would be feasible for a profit-motivated entity. Moreover, the officials said that the Enterprises' relatively low guarantee fees provided them with an advantage over potential competitors that has contributed to their long dominant position in the U.S. housing finance system. Further, FHFA believes that the Enterprises' relatively low guarantee fees amplified their risks because, as recent experience demonstrates, the fees did not fully reflect the potential credit losses that the Enterprises could incur in fulfilling their commitments to their MBS investors.

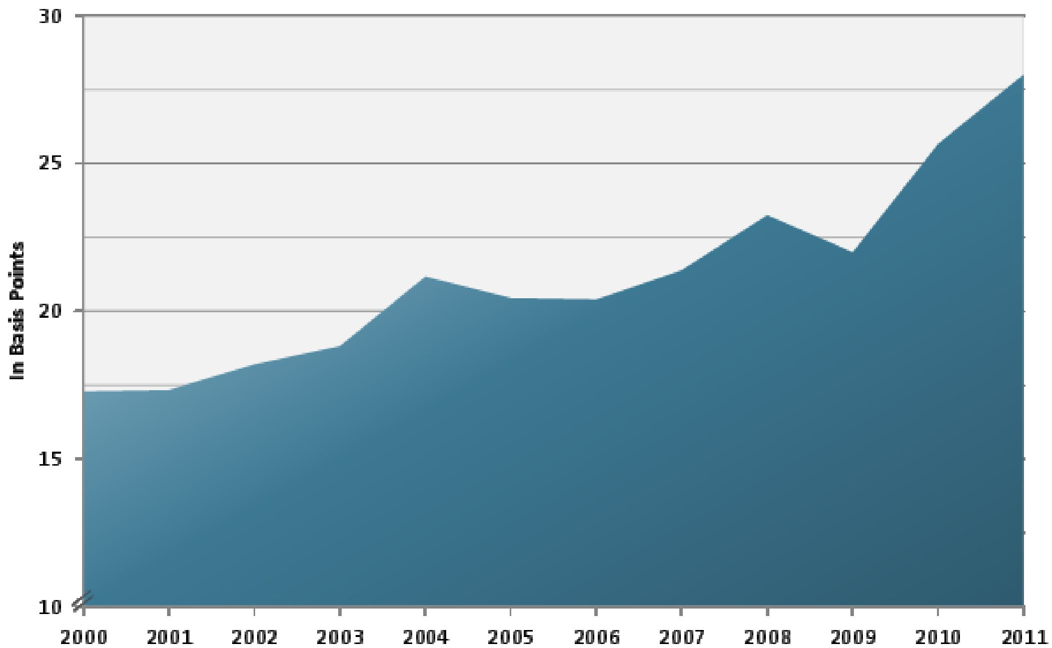
The Enterprises' Guarantee Fees During the Housing Boom Did Not Cover Their Subsequent Credit Losses

During the housing boom of 2004 through 2007, the Enterprises' guarantee fee rates were too low to mitigate the risks associated with their mortgage purchase and securitization practices. FHFA has argued that this was due in part to the comparative advantage that the Enterprises enjoyed due to the implicit federal guarantee of their obligations. Starting in late 2007, the Enterprises began to increase their guarantee fees to protect themselves better against potential credit losses, and this trend generally continued under the FHFA conservatorship through 2011.

Enterprise Guarantee Fees Were Set Too Low During the Housing Boom

As shown in Figure 3, the Enterprises' combined average guarantee fees increased from 17 basis points in 2000 to 21 basis points at the end of the first year of the housing boom in 2004. During the housing boom years of 2004 through 2007, the average guarantee fees remained at about 21 basis points. After declining slightly in 2009, the guarantee fees increased to about 28 basis points by 2011.

FIGURE 3. ESTIMATED ENTERPRISE AGGREGATED ANNUAL SINGLE-FAMILY GUARANTEE FEE PRICING, 2000-2011[34]



FHFA and Enterprise officials explained that the guarantee fees, which averaged 21.4 basis points in 2007, did not offset the losses that the Enterprises were incurring through their mortgage securitization businesses.[35] That is, the Enterprises were purchasing large volumes of higher risk mortgages, such as Alt-A loans, packaging them into MBS, and selling them to investors. Ultimately, many of these higher risk mortgages defaulted and the Enterprises suffered $218 billion in losses on their single-family MBS guarantee business.[36] These losses exceeded their available capital of about $78 billion at the beginning of the conservatorship by a factor of nearly three to one.[37]

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[34] Source: FHFA based on Fannie Mae and Freddie Mac data. The data represent the estimated average guarantee fee charged by Fannie Mae and Freddie Mac on single-family mortgages delivered on a flow basis in 2000 through 2011. The estimate for 2011 does not include loans originated under the Home Affordable Refinance Program.

[35] OIG observes that if the Enterprises had correctly anticipated the credit risks they incurred during the housing boom then they would have set their guarantee fees much higher than their 2007 average of 21.4 basis points.

[36] Officials from one Enterprise observed that many prime mortgages defaulted during the financial crisis as well.

[37] *See* FHFA, *Conservator's Report on the Enterprises' Financial Performance First Quarter 2012*, at 9 (online at http://www.fhfa.gov/webfiles/24016/Conservator'sReport1Q2012061512_FINAL.pdf). The $218 billion in losses is a comprehensive income figure upon which Treasury investments are calculated; net income figures reported by the Enterprises may differ.

FHFA and Enterprise officials provided several reasons for the low guarantee fees set during the housing boom years. For example, they said that the Enterprises' financial models severely underestimated the credit default risks associated with Alt-A and other higher risk mortgages.[38] Moreover, the financial models failed to predict the drastic decline in house prices caused by the collapse of the housing bubble.

However, FHFA and Enterprise officials also conceded that the guarantee fees that the Enterprises set were sometimes lower than what was called for by their financial models. For example, data from one Enterprise showed that from 2000 through 2008 its guarantee fees were always set below the rates specified by its modeling. Enterprise officials said that these lower guarantee fees were based, in part, upon business decisions to make its MBS competitive with PLMBS issuances.

FHFA and the Enterprises Initiated Actions to Address Guarantee Fee Pricing Deficiencies During the Period 2007 Through 2011

In response to escalating credit losses on their MBS guarantee business, in late 2007 both Enterprises announced increases of 25 basis points in their upfront guarantee fees. These increases were implemented in March 2008.[39] From 2008 through 2011, the Enterprises, under their FHFA conservatorships, began to address certain aspects of guarantee fee cross-subsidization, such as differences based on mortgage loan risk characteristics.[40] In addition, FHFA required them to make additional changes to address cross-subsidization in 2012.[41] FHFA and the Enterprises' efforts to reduce cross-subsidization in guarantee fee pricing are discussed in more detail in Appendix A.

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[38] Alt-A loans involve significant risks, including limited documentation of borrowers' income and assets. During the housing boom, the Enterprises established numerous variances to their traditional underwriting standards. This, in turn, provided for increased purchases of Alt-A and other higher risk mortgage assets. *See, e.g.,* OIG, *FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards* (AUD-2012-003) (March 22, 2012) (online at http://fhfaoig.gov/Content/Files/AUD-2012-003_0.pdf).

[39] The Enterprises collect both upfront and annual guarantee fees. *See* note 26 *supra*.

[40] The Enterprises make publicly available the matrices for calculating their risk-based upfront fees. *See* Fannie Mae, *Loan-Level Price Adjustment (LLPA) Matrix and Adverse Market Delivery Charge (AMDC) Information* (September 20, 2012) (online at https://www.fanniemae.com/content/pricing/llpa-matrix.pdf); and Freddie Mac, *Single-Family Seller/Servicer Guide, Exhibit 19—Postsettlement Delivery Fees* (September 14, 2012) (online at http://www.freddiemac.com/singlefamily/pdf/ex19.pdf).

[41] For example, the Enterprises traditionally charged high-volume mortgage sellers guarantee fees that were lower than those charged to low-volume sellers. The Enterprises did so, in part, because large lenders were able to negotiate reductions in fees based upon the large volume of loans they were able to deliver. As described in Appendix A, FHFA took steps to address these guarantee fee imbalances starting in 2012.

Enterprise Guarantee Fees Increased Significantly in 2012, and FHFA Has Stated That Gradual Increases Will Continue as a Means to Increase Private Sector Investment in Mortgage Credit Risk

The Enterprises nearly doubled their combined average guarantee fees to 50 basis points in 2012 due to a legislative mandate and a directive issued by FHFA. According to FHFA, it will continue to direct the Enterprises to increase gradually their guarantee fees over time in order to reduce their dominance in housing finance (by increasing private sector investment) and limiting taxpayer risks associated with their activities. However, it is not clear how much higher fees will have to increase in order to increase private sector investment in mortgage credit risk. Moreover, FHFA has not yet defined how it will measure increased private sector investment in mortgage credit risk, which raises the level of uncertainty associated with the Agency's initiative.

Legislation Enacted in 2012 Required the Enterprises to Increase Guarantee Fees

The *Temporary Payroll Tax Cut Continuation Act of 2011* required FHFA to increase the Enterprises' guarantee fees on single-family MBS by not less than 10 basis points above the average guarantee fee that they charged in 2011 on single-family MBS. The effective date of the Act was April 1, 2012. This statutorily directed increase was not intended to benefit the business and financial condition of the Enterprises. Rather, it was designed to raise federal revenue—for a period of 10 years—and thereby offset costs associated with the temporary reduction in payroll taxes.

FHFA Required the Enterprises to Increase Guarantee Fees in 2012 as Part of an Ongoing Plan to Reduce Their Dominance in the Housing Finance System and to Support Housing Finance Reform

In August 2012, FHFA announced an additional average increase of 10 basis points in Enterprise guarantee fees as part of an overall plan to increase private sector investment in mortgage credit risk and gradually end the Enterprises' dominance in the housing finance system.[42] Since the onset of the conservatorships, taxpayers have stood behind the credit guarantees on the Enterprises' MBS issuances. FHFA believes that private investment in mortgage credit risk may increase if the Enterprises' federally supported cost advantages are

[42] FHFA targeted the 10 basis point increase to promote uniformity between the guarantee fees paid by large- and small-volume lenders. The Agency also sought to apply a greater portion of the increase to higher risk long-term loans than to loans with a term of 15 years or less. The increase went into effect on November 1, 2012, for loans sold to the Enterprises for cash, and on December 1, 2012, for loans exchanged for MBS. For more information *see* FHFA, *FHFA Announces Increase in Guarantee Fees, G-fee Report for 2010-2011 Released* (August 31, 2012) (online at http://www.fhfa.gov/webfiles/24259/Gfee083112.pdf).

somewhat offset by increases in their guarantee fees. Accordingly, the Agency also believes that its initiative will cause private investors and institutions to take on some of the risk currently borne by taxpayers.[43]

FHFA has stated that its initiative is consistent with efforts by Congress and the Administration to reform the housing finance system. Many housing finance reform proposals call for the elimination of the Enterprises in their current form and their replacement with a new structure. For example, in 2011 HUD and Treasury issued a white paper that proposed several approaches to housing finance reform all of which would eliminate the Enterprises in their current form. FHFA's proposal to downsize gradually the Enterprises' market presence appears to be an attempt to provide a foundation for whatever strategy is ultimately adopted.[44]

The following example illustrates one means by which **raising the Enterprises' guarantee fees** might increase private sector investment in mortgage credit risk. Suppose that a private sector firm wished to compete with the Enterprises in purchasing conforming loans from lenders and converting them into PLMBS. Given that the Enterprises offer guarantees to investors, the private sector firm would need to offer similar guarantees to entice investor interest in its securities. However, the Enterprises, due to their federal support, could likely charge guarantee fees well-below the fees that the private sector firm would charge for similar guarantees. If FHFA requires the Enterprises to raise their guarantee fees to the levels that the private sector firm can offer, then lenders might be more willing to sell their loans to the private firm.

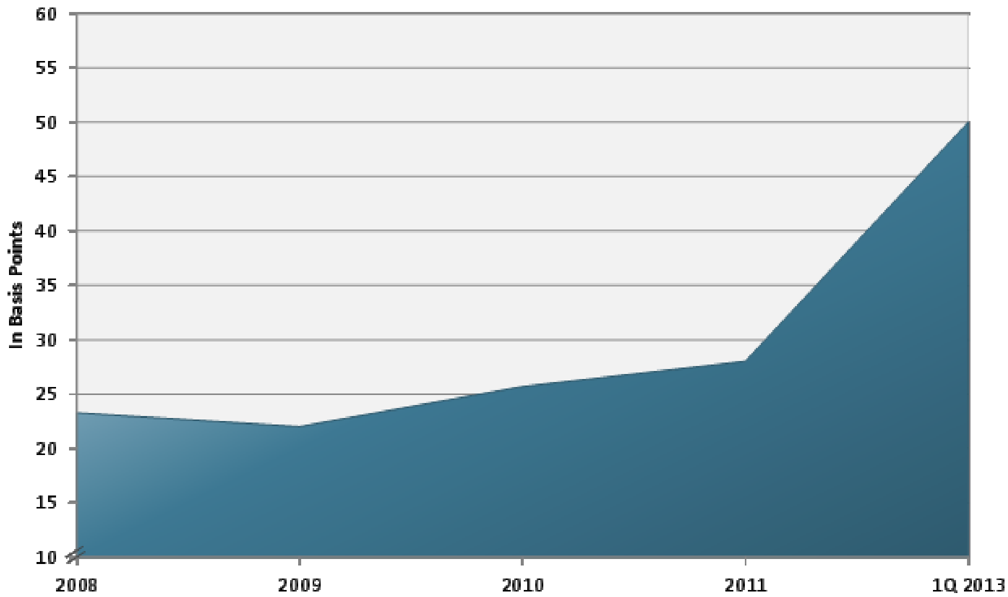
The Amount by Which Guarantee Fees Must Rise in Order to Increase Private Sector Investment Is Unclear

As shown in Figure 4, the two mandated guarantee fee increases in 2012 caused the Enterprises' combined guarantee fee to nearly double from 28 basis points in 2011 to 50 basis points by the first quarter of 2013.

[43] *See* FHFA, *A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending* (February 21, 2012) (online at http://www.fhfa.gov/webfiles/23344/StrategicPlanConservatorshipsFINAL.pdf); and Senate Committee on Banking, Housing, and Urban Affairs, Statement of Edward J. DeMarco, Acting Director, Federal Housing Finance Agency, *An Update from the Federal Housing Finance Agency on Oversight of Fannie Mae, Freddie Mac and the Federal Home Loan Banks* (April 18, 2013) (online at http://www.fhfa.gov/webfiles/25114/DeMarcoSenateBankingTestimony41813.pdf).

[44] *See* OIG, *Semiannual Report to the Congress: October 1, 2012, through March 31, 2013*, Section 3 "Enterprise Reform" (online at: http://www.fhfaoig.gov//Content/Files/EnterpriseReform.pdf).

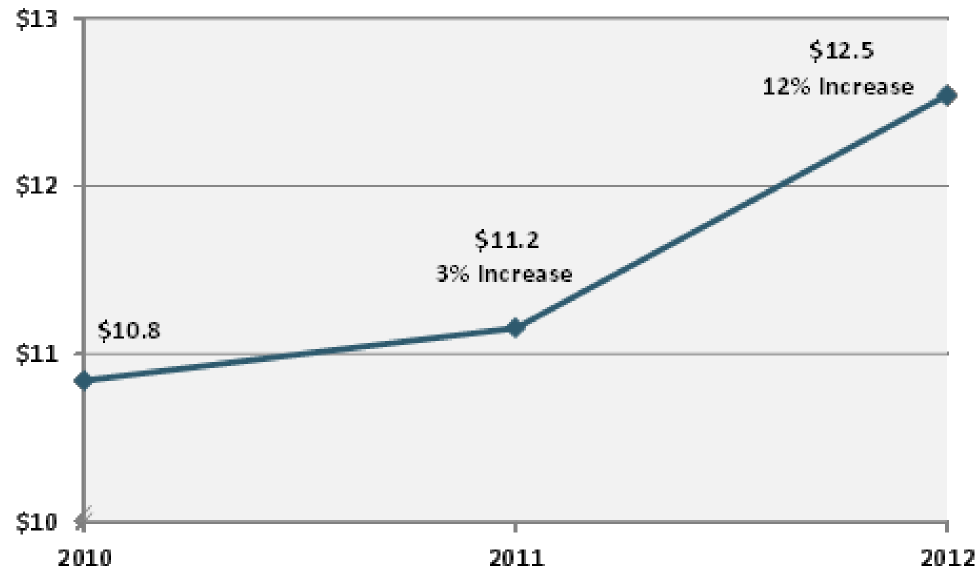
FIGURE 4. ESTIMATED ENTERPRISE AGGREGATED ANNUAL SINGLE-FAMILY GUARANTEE FEE PRICING, 2008–MARCH 31, 2013[45]



Moreover, the Enterprises' guarantee fee income grew 12% in 2012 to $12.5 billion (see Figure 5).

[45] Source: Estimates for 2008 to 2011 were provided by the FHFA Office of Policy Analysis & Review based on Fannie Mae and Freddie Mac data. The data represent the estimated average guarantee fees charged by Fannie Mae and Freddie Mac on single-family mortgages delivered on a flow basis in 2008 through 2011. The estimate for 2011 does not include loans originated under the Home Affordable Refinance Program. The first quarter 2013 estimate is based upon the testimony of FHFA Acting Director Edward J. DeMarco before the House Committee on Financial Services. *See* House Committee on Financial Services, Statement of Edward J. DeMarco, Acting Director, Federal Housing Finance Agency, *On Sustainable Housing Finance: An Update from the Federal Housing Finance Agency on the GSE Conservatorships*, at 6 (March 19, 2013) (online at http://www.fhfa.gov/webfiles/25037/DeMarcoHFSC319testimony.pdf).

FIGURE 5. ENTERPRISE GUARANTEE FEE INCOME, 2010-2012 *IN BILLIONS*[46]



The Enterprises expect to continue to realize additional guarantee fee income based on recent and planned increases in their fees.[47]

Although recent guarantee fee increases have been substantial, available evidence suggests that they may not be sufficient to cause a material increase in private sector investment in mortgage credit risk. Enterprise officials told OIG that their current guarantee fees are generally consistent with what their financial models indicate are necessary to cover the costs associated with purchasing and securitizing loans and generating reasonable returns on

[46] Source: Fannie Mae, *2012 Annual Report on Form 10-K*, at 75, F-66-F-68 (April 2, 2013) (online at http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/10k_2012.pdf) and Freddie Mac, *2012 Annual Report on Form 10-K,* at 280, 281 (February 28, 2013) (online at http://www.freddiemac.com/investors/sec_filings/).

[47] For example, Fannie Mae stated in its 2012 Annual Report:

> As a result of increases in our charged guaranty fee and the larger volume of single-family loans we acquired in 2012, we expect to receive significantly more guaranty fee income on the single-family loans we acquired in 2012, over their lifetime, than on the single-family loans we acquired in 2011. We expect rising guaranty fee revenue we receive for managing the credit risk on loans underlying Fannie Mae MBS held by third parties will in a number of years become the primary source of our revenues, particularly as we reduce the size of our mortgage portfolio to comply with the terms of the senior preferred stock purchase agreement. Moreover, if current market conditions continue, we expect these revenues will generally offset expected declines in the revenues we generate from the difference between the interest income earned on the assets in our mortgage portfolio and the interest expense associated with the debt funding of those assets.

See Fannie Mae, *2012 Annual Report on Form 10-K*, at 2 (April 2, 2013) (online at http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/10k_2012.pdf).

capital.[48] However, an official from one Enterprise said that guarantee fees, in general, would need to rise considerably in order to materially increase private sector investment because they are not yet high enough to offset the traditional cost advantages that the Enterprises derive from federal financial support. A representative of a private company currently engaged in the securitization of jumbo mortgages similarly advised that the Enterprises' guarantee fee rates would need to increase another 15 to 20 basis points—roughly 1/3 higher—before market participants would begin to have sufficient financial incentives to expand their current role in housing finance.[49]

FHFA officials recognize that guarantee fees should increase gradually in order to increase private sector investment without causing meaningful disruption to the housing finance market. Agency officials have said that, going forward, guarantee fee increases would likely be modest, and there will be considerable intervals between each increase. The officials explained that this approach will permit the Agency to assess periodically the financial markets' reactions to the fee increases and make adjustments as necessary.

Definitions of Increased Private Sector Investment in Mortgage Credit Vary

Evidence as to whether the guarantee fee rate increases are encouraging additional private sector investment in mortgage credit could vary significantly. The Agency has not developed any fixed definitions or methods by which to measure this phenomenon. For example, such evidence might include a gradual return of a revamped PLMBS market, perhaps to historical levels that, on average, were about 20% of all MBS issuances in the 1990s. Short of that, an FHFA official said, financial institutions might be more willing to hold mortgage loans in their portfolios rather than sell them to the Enterprises. This, in effect, would result in the banking sector retaining a greater percentage of the credit and risks associated with mortgage origination instead of transferring them to the Enterprises.[50]

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[48] Enterprise officials also said that stronger credit underwriting standards since 2008 have resulted in significantly lower credit cost projections than during the housing boom years. However, officials from one Enterprise said that current guarantee fees on some higher risk loans are not yet high enough to ensure a reasonable return on capital.

[49] *See* House Committee on Financial Services, *Hearing on Building a Sustainable Housing Finance System: Examining Regulatory Impediments to Private Investment Capital*, 113th Cong. (April 24, 2013).

[50] Recent evidence on lender retention of mortgage loans is mixed. There was some evidence of this in 2012 as *Inside Mortgage Finance* reported that banks and thrifts increased their holdings of first-lien mortgages by 2.3% over the year to $1.8 trillion, even as three of the four largest holders of whole loans reduced their portfolios. *See* "Bank Holdings of First-Lien Mortgages Increased in 2012, Including Conforming and Non-Agency Loans," *Inside Mortgage Finance* (March 29, 2013). On the other hand, officials from one Enterprise said that lender commitments to sell their mortgage loans have been increasing in 2013, which is an indicator that mortgage retention is not increasing as of yet. However, analysis provided by the other Enterprise indicates that as guarantee fees continue to rise an uptick in the rate of lender retention in the near-term is a real possibility, especially for well-capitalized banks.

Alternatively, an FHFA official said, the guarantee fees might increase private sector participation in housing finance "on the margin;" that is, private institutions might be more willing to compete with the Enterprises for the purchase of particular pools of mortgages, but not conforming mortgages in general.

Officials from one Enterprise agreed with FHFA. They told OIG that definitions of increased private sector investment in mortgage credit could vary and be difficult to measure. For example, the private sector generally did not securitize the types of conforming mortgages that are the staple of the Enterprises' MBS guarantee businesses. Rather, they generally securitized into PLMBS those non-conforming mortgages that did not meet the Enterprises' underwriting standards. Although the private sector might be willing to securitize conforming mortgages if guarantee fees increase substantially, there is no historical track record of such securitizations. The Enterprise official also said that increasing lender retention of mortgages would not necessarily indicate that rising guarantee fee rates were increasing private sector investment in mortgage credit risk. Enterprise-related credit costs, such as guarantee fees, are a relatively smaller factor in a lender's decision to sell a mortgage to an Enterprise or retain it on its books.[51]

Trade-offs and Challenges Associated with FHFA's Initiative to Increase Private Sector Investment by Raising Guarantee Fees

While FHFA's initiative has the potential to transfer some of the credit risk currently borne by the Enterprises to private sector investors, it also faces some trade-offs and challenges including: (1) a reduced demand for mortgage credit and volume under some scenarios; (2) potential limits on private sector incentives to invest in mortgage credit resulting from federal regulatory initiatives; and (3) potential shifts in mortgage credit and risks between the conforming and government insured markets.

Under Some Scenarios, Rising Guarantee Fees Could Limit Private Sector Investment in Mortgage Credit Risk

To some degree, the Enterprises' guarantee fees have always been built into the cost of conforming mortgages. For example, the fees are sometimes expressed as a component of the interest rate associated with a mortgage loan, or simply a cost of obtaining it.[52] Given the relatively low guarantee fees over the years, it is likely that their inclusion in the overall

[51] For example, the official said that banks must consider the interest rate risks associated with holding mortgages in their portfolios.

[52] As discussed previously, large lenders pay MBS fees directly to the Enterprises. Typically, these guarantee fees are passed on to borrowers through lender-initiated increases in mortgage interest rates as most borrowers prefer not to pay upfront fees as a part of their closing costs. *See FHFA Guarantee Fee Study*, at 4.

price of single-family mortgages has had only a minimal effect on the demand for housing finance.

However, as the Enterprises' annual guarantee fees continue to rise they could become an increasingly important factor in the overall cost of conforming mortgages. Any business facing increased operating costs, such as a lender in the primary mortgage market, must decide how much of those cost increases to pass-on to its customers.[53] If guarantee fee increases are limited and housing and economic markets are strong, then the impact of guarantee fee increases upon borrowers will likely be mitigated.[54]

On the other hand, if guarantee fee increases and long-term mortgage interest rates increase significantly, then the relative attractiveness of housing finance to potential private sector participants might be limited due to reduced borrower demand and mortgage origination volume.[55] As a result, FHFA may face challenges in reducing the Enterprises' role in housing finance through guarantee fee increases.[56]

Federal Regulatory Initiatives Could Limit the Interest of Private Market Participants in Additional Mortgage Credit Risk Investment

Moreover, recent federal regulatory initiatives designed to correct abusive and unsafe housing-boom era lending practices could involve trade-offs that present a challenge to FHFA's initiative.[57] For example, in January 2013, the Consumer Financial Protection Bureau (CFPB) proposed the "Ability-to-Repay" Rule, which is designed to ensure that lenders originate mortgage loans that borrowers have the financial resources to repay.[58]

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[53] The decision to pass on a portion of increased costs to downstream customers would depend, in part, upon the relative competiveness of the relevant business environment.

[54] One FHFA official said that recent guarantee fee increases have had a modest "dampening" effect on current mortgage demand. An Enterprise official said it is likely that lenders will pass on to borrowers most or all of the costs associated with additional guarantee fee increases.

[55] Economists define the relationship between price and quantity as "the price elasticity of demand." Price elasticity measures the responsiveness of the quantity of a good or service that is demanded to a change in its price. In this scenario, the degree of the price elasticity of demand would determine whether and how much an increase in guarantee fees would increase (or decrease) borrower demand for mortgages and the total revenue from mortgage originations.

[56] Officials from one Enterprise observed that higher guarantee fees could incent private sector investment in mortgage credit risk due to the potential for higher returns.

[57] In this discussion, OIG does not imply any opposition to the federal regulatory initiatives that are mentioned or their objectives. We are simply noting arguments raised by FHFA and others that a trade-off of the rules is that they may limit the Agency's capacity to achieve its stated objectives in raising the Enterprises' guarantee fees.

[58] The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (Dodd-Frank Act) established the CFPB. It is an independent bureau within the Federal Reserve System with responsibility for protecting consumers from abusive financial services practices. CFPB serves as a single point for accountability for

Central to the Rule are "qualified mortgages." Lenders that originate such mortgages are provided with substantial legal protections.[59]

Some financial analysts have concluded that the Rule's definition of a qualified mortgage could have a negative impact upon the creation or revival of private investment in mortgage credit risk.[60] For example, due to a lack of legal protections for subprime mortgages and mortgages that do not meet the qualified mortgage definition, investor demand for MBS collateralized by such mortgages may be limited. In addition, an FHFA official said that the current definition of a qualified mortgage could ensure the primacy of the Enterprises' underwriting standards over those for non-conforming loans for a considerable period.[61] In other words, originating conforming mortgages will offer lenders litigation benefits for at least the next seven years.

FHFA officials also cited the credit risk retention rule in the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (Dodd-Frank Act) as potentially limiting private sector financial incentives to increase their level of mortgage credit risk.[62] The law

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consumer financial protection within the federal government, covering the jurisdiction previously shared by seven federal agencies. CFPB also conducts rulemaking; supervises and enforces federal consumer financial laws; handles consumer complaints and inquiries; promotes financial education and research into consumer behavior; and monitors financial markets for risks to consumers. *See* CFPB, "Section 1 – Purpose," *Fiscal Year 2012 CFPB congressional justification* (2011) (online at http://files.consumerfinance.gov/f/2011/02/CFPB-2012-CJ.pdf) and CFPB, "Section 1B – Mission, Priorities, and Context," *FY 2013 Budget Justification* (2012) (online at http://files.consumerfinance.gov/f/2012/02/budget-justification.pdf).

[59] Under the proposed Ability-to-Repay Rule, qualified mortgages will be granted protections from borrower recourse, and some loans will qualify for a safe harbor from borrower-initiated legal challenges on the basis of underwriting if the loan goes into default. In general, mortgages for which the borrower has a debt-to-income ratio less than or equal to 43% will be eligible for qualified mortgage status, assuming other requirements are satisfied. The loans cannot include up-front fees in excess of 3%, and certain subprime mortgages, such as Alt-A and interest-only loans, would not be considered qualified mortgages under the proposed rule. The CFPB also provides for a 7-year transition period during which loans with a debt-to-income ratio above 43% that meet the underwriting standards of the Enterprises will be considered qualified mortgages under the proposed Rule. For more information on the Ability-to-Repay rule, *see*, CFPB, "Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z)," (online at http://www.consumerfinance.gov/regulations/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z/).

[60] *See* Deloitte, *First Look: Implications of the ability-to-repay rule and the qualified mortgage definition* (online at http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/US_FSI_FirstLook_012413.pdf); Rachel Wikowski, "Will the Qualified Mortgage Rule Kill the Subprime Mortgage?," *American Banker* (January 11, 2013); and Richard Booth, "How to Stymie Mortgage Lending: QM Rule Edition" (op-ed), *American Banker* (January 25, 2013).

[61] The official was commenting upon the provision in the proposed rule that would establish a 7-year transition period during which mortgages that comply with the Enterprises' underwriting standards and held by borrowers with debt-to-income ratios above 43% would meet the definition of a qualified mortgage.

[62] *See* Dodd-Frank Act, Pub. L. 111-203 § 941, 124 Stat. 1890 (2010). *See also* Credit Risk Retention, 76 Fed. Reg. 24089 (proposed April 29, 2011).

requires issuers of securities backed by residential mortgages to retain no less than 5% of the credit risk on any mortgage they securitize that does not meet specified criteria. Although this requirement is intended to prevent the types of risky securitization practices that took place during the housing boom era, the requirement that securitizers retain some credit risk could make them less willing to participate in the business of converting mortgages to MBS.[63]

FHFA's and FHA's Initiatives Could Result in a Shifting of Housing Finance Volume from One Government Supported Mortgage Market to the Other Without a Corresponding Increase in Overall Private Sector Investment

As discussed previously, FHA has raised its mortgage insurance premiums and tightened its underwriting standards in recent years as a way to strengthen its finances and encourage greater private sector investment in mortgage credit risk. In this regard, FHA's and FHFA's initiatives have consistently sought to bring about a reduction in the federal government's currently dominant position in supporting housing finance.

However, there is some potential that the FHFA and FHA initiatives could result in one of their respective markets—the conforming market or the government insured or guaranteed market—becoming relatively more expensive or otherwise less attractive than the other. For example, as the Government Accountability Office (GAO) has observed, Enterprise guarantee fee increases could shift mortgage business and risks to FHA. GAO stated that, in reducing the Enterprises' role in the housing finance system, FHFA should consider the risks posed to FHA.[64]

An FHFA official said that he does not consider the potential for such material shifts among the mortgage markets to be high. Further, over the past several years, both the Enterprises and FHA have raised prices without material shifts in business between them.[65] The official added that there is not much overlap between the conforming mortgage market and the

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[63] GAO, *Mortgage Reform: Potential Impacts of the Provisions in the Dodd-Frank Act on Homebuyers and the Mortgage Market* (GAO-11-656, July 2011) (online at http://www.gao.gov/new.items/d11656.pdf). Other analysts have cited pending Basel III capital requirements as having the potential to make it more expensive for private capital to return to the housing finance system. *See*, *e.g.*, Fitch Ratings, *Regulators Have Room to Spur Private U.S. Mortgage Market* (March 7, 2013) (online at http://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Regulators-Have-Room?pr_id=785379&cm_mmc=ExactTarget-_-Email-_-LM_FW_NA_NYC_2013Mar07-_-0000); and Compass Point Research & Trading, LLC, *Washington Policy Flash Note* (April 1, 2013).

[64] *See* GAO, *High-Risk Series: An Update* (GAO-13-283) (February 2013) (online at http://gao.gov/assets/660/652133.pdf).

[65] OIG observes that some material Enterprise increases in guarantee fees did not go into effect until the second half of 2012 and, therefore, it is likely that sufficient time has not passed to assess the implications of these increases.

FHA-insured market. For example, he said FHA's single-family mortgage insurance program has been of benefit primarily to borrowers who may present greater credit risk and first-time homebuyers.

OIG recognizes the existence of these differences, but we also note the following:

- The current maximum amount of an FHA-insured mortgage for a single-family property—$729,750 in certain high cost areas—is significantly higher than the $625,500 conforming loan limit for the same areas. This could increase the relative attractiveness of FHA-insured mortgages.[66]
- Although FHFA has directed the Enterprises to raise their guarantee fees in recent years, Ginnie Mae has not raised its MBS guarantee fee since 1972.[67] Consequently, some financial analysts believe, there is a growing cost disadvantage between Ginnie Mae guaranteed MBS and the Enterprises' MBS, which could cause investor interest in Ginnie Mae guaranteed MBS to increase on a relative basis.[68]
- Officials from one Enterprise said that there is some overlap between its business and that of FHA.[69] Specifically, the Enterprise has packaged certain higher risk mortgages into MBS that may also be eligible to be insured by FHA. The officials also said that they continually monitor their pricing on these mortgages relative to FHA's pricing to mitigate potential credit risks.
- HUD announced in April 2013 that FHA would no longer increase its mortgage insurance premiums. As a result, if FHFA continues to direct the Enterprises to increase their guarantee fees over time, then the potential exists for conforming mortgages and the Enterprises' MBS to become relatively more expensive than FHA insured mortgages and Ginnie Mae issued MBS. This, in turn, could result in a shift in some current mortgage business and risks from the Enterprises to FHA/Ginnie Mae, i.e., government insured or guaranteed markets.

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[66] Officials from one Enterprise observed that FHA insurance premiums generally do not vary based on risk. In contrast, as described in Appendix A, the Enterprises and FHFA are raising and revising guarantee fees to better reflect relevant risks. This could result in a flow of Enterprise business to FHA as the latter's premium structure may prove to be less expensive.

[67] According to Ginnie Mae, its guarantee fees have remained at 3 to 6 basis points since 1972 except in certain targeted risk areas. However, Ginnie Mae emphasized that its risks differ from those of the Enterprises in that the Enterprises are responsible for credit losses while Ginnie Mae is not.

[68] *See*, Brian Collins, "Ginnie Could Gain From Fannie/Freddie G-Fee Hikes," *National Mortgage News* (September 10, 2012) (online at http://www.nationalmortgagenews.com/features/fannie-freddie-guarantee-fee-hikes-could-benefit-ginnie-1032118-1.html?site=default_on). OIG notes that Ginnie Mae guaranteed MBS also contain other mortgage insurance premiums, such as those charged by FHA, in their pricing structure.

[69] Officials from the other Enterprise said its overlap with FHA is currently minimal.

FINDINGS ....

1. FHFA Has Yet to Establish Definitions or Performance Measures for Its Initiative

FHFA has not yet developed definitions of "increased private sector investment in mortgage credit risk" or ways to measure such an increase. The term could mean something as modest as a limited increase in competition between the private sector and the Enterprises with respect to the purchase of certain mortgage assets. Conversely, it could mean something as far-reaching as a return of a revamped PLMBS market perhaps to historical levels that, on average, were about 20% of all MBS issuances in the 1990s.

FHFA officials contacted by OIG questioned the appropriateness and practicality of developing definitions or measures of additional private sector investments in mortgage credit risk. They said that the Agency has taken a pragmatic approach, recognizing that the Enterprises have traditionally underpriced their services relative to the private market. Further, as the Enterprises' conservator, FHFA's role is gradually to rectify such underpricing and attendant risks by, among other things, raising their guarantee fees. At some point, the officials said, rising guarantee fees will make substantial private sector investments in mortgage credit risk inevitable unless Congress first acts to redefine the Enterprises and their role in the housing finance system. Accordingly, the officials said, it is unclear to them why, in the short term, FHFA should develop specific definitions and measures of increased private sector investments in mortgage credit risk.

OIG is not persuaded by FHFA's stated rationale for declining to develop definitions and performance measures for its pricing initiative.[70] First, the *GPRA Modernization Act of 2010* establishes that federal agencies such as FHFA should develop balanced performance measures for their programs.[71] There are a range of potential indicators of private sector mortgage investment activity, such as PLMBS issuances, that the Agency could track in its public planning documents. By choosing to do so, FHFA would enhance transparency around its initiative; that is, it would permit independent observers to assess the Agency's progress in meeting its objectives over time.[72] Second, there is no guarantee that Congress

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[70] In this regard OIG notes that FHFA has developed specific performance objectives for its risk-sharing initiative. *See* Appendix B.

[71] Under the Act, FHFA is required to establish a balanced set of performance indicators and provide a basis for comparing actual program results with those performance indicators.

[72] We recognize that it may not be feasible for FHFA to develop specific targets for its objectives (e.g., PLMBS issuance will achieve a specific percentage of all MBS issuances by a particular date). Nevertheless,

will act on housing finance reform in the short-term and, whenever Congress acts, it is likely that there will be a significant period of transition before the revised housing finance system is in place. During this transition period, which could be lengthy, it is likely that the Enterprises will be increasing their guarantee fees at FHFA's direction. Therefore, OIG believes that the method by which the Agency defines and measures the progress of its guarantee fee initiative over this period should be as clearly stated as possible.[73]

2. FHFA Should Seek to Establish a More Formalized Arrangement with FHA to Assess Key Issues Involving Their Pricing Initiatives

Although FHFA and FHA have held periodic meetings on their pricing initiatives in recent years, they have not established a formal working group, such as the one recommended by the 2011 HUD/Treasury white paper on housing finance reform. We do not necessarily endorse the specific aspects of the white paper's working group proposal. However, we believe that there are potential benefits that FHFA may achieve by seeking to establish a more formalized working arrangement with FHA and jointly assessing the key issues around their pricing initiatives.[74]

The 2011 HUD/Treasury white paper observed that efforts to decrease the roles of the Enterprises and FHA in the housing finance system require great care, particularly given the system's current fragility.[75] In addition, the white paper recommended the creation of a formal FHFA/FHA working group to consider changing the prices of items, such as the Enterprises' guarantee fees and FHA's insurance premiums, as a way to reduce the federal government's role in housing finance. The white paper further recommended that the working group ensure transparency by seeking public comment on the most appropriate pace at which to transition to a housing finance system with greater private sector participation and issue a timeline for tightening underwriting standards and raising pricing.

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we believe that it is reasonable to expect FHFA to identify in its public planning documents thresholds that would be indicative of healthy private sector investment activity or trends.

[73] In a 2011 report, we stated that it was important for financial market participants to understand FHFA's basis for raising guarantee fees to reduce the Enterprises' market presence. Without such critical information market participants may lack the ability to adjust to changes in guarantee fees. This, in turn, could affect financial market stability and mortgage availability and terms. *See* OIG, *Federal Housing Finance Agency's Exit Strategy and Planning Process for the Enterprises' Structural Reform* (EVL-2011-001) (March 31, 2011) (online at http://fhfaoig.gov/Content/Files/EVL%20Exit%20Strategy%20-%20DrRpt%2003302011-final%2C%20signed.pdf).

[74] OIG recognizes that FHFA's capacity to increase interactions depends upon FHA's willingness to reciprocate.

[75] OIG notes that, under the *Government Performance and Results Act of 1993* (GPRA), agencies pursuing similar strategic goals must coordinate their actions. *See* GAO, *Agencies' Strategic Plans Under GPRA: Key Questions to Facilitate Congressional Review* (GAO/GGD-10.1.16) (May 1997) (online at http://www.gao.gov/special.pubs/gpraqu.pdf).

Finally, the white paper recommended that the FHFA/FHA working group: (1) provide regular updates to the Federal Housing Finance Oversight Board (FHFOB) and the Financial Stability Oversight Council (FSOC) as the reforms are implemented; and (2) continue to seek public comments and revise the timeline to account for changing market conditions and accelerate the timeline when possible.[76]

Although FHFA has taken several steps to communicate with FHA about their mutual pricing initiatives, the formal working group recommended by the HUD/Treasury white paper has not been established.[77] FHFA officials said that over the past several years they have met with FHA to discuss their pricing initiatives and that these meetings have been beneficial.[78]

We believe that there may be additional benefits that FHFA can achieve by establishing a more formal and ongoing working arrangement with FHA within which they jointly assess the critical issues that they confront.[79] OIG observes that, in the absence of such an arrangement:

- FHFA and FHA have not jointly assessed the implementation of their pricing initiatives, their prospects for success, and the potential for shifts in mortgage business and the associated risks between the government supported and government insured markets. We note, as discussed earlier, that an assessment of the potential for shifts among mortgage markets may be particularly important now given FHFA's intent to continue raising the Enterprises' guarantee fees, in contrast to HUD's decision to end further FHA mortgage insurance premium increases; and

[76] The FHFOB was established in the Housing and Economic Recovery Act of 2008 to provide policy and strategic advice to the Director of FHFA. It consists of the Director, who chairs the Board, the Secretaries of Departments of the Treasury and Housing and Urban Development, and the Chairman of the Securities and Exchange Commission. *See* 12 U.S.C. § 4513a. The FSOC was established by the Dodd-Frank Act to identify risks to financial stability and promote market discipline. It is a ten-member interagency council chaired by the Secretary of the Treasury and its membership is comprised of the heads of all the federal banking and securities market regulatory agencies, the Director of FHFA, and a member of the general public. *See* 12 U.S.C. § 5321.

[77] FHFA officials said they did not think that a formal working group would have produced any additional benefits with respect to the Agency's interactions with FHA on their pricing initiatives.

[78] An FHFA official said that the Agency has met with Ginnie Mae officials on MBS guarantee pricing.

[79] OIG observes that FHFA has collaborated with FHA in other initiatives. In 2011, FHFA formed an interagency working group, which included HUD, Treasury, and other agencies, to assist in its design of the pilot program under which Fannie Mae sold certain foreclosed properties with rental commitments. *See* House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises, *Statement of Meg Burns, Senior Associate Director for Housing and Regulatory Policy, An Examination of the Federal Housing Finance Agency's Real Estate Owned (REO) Pilot Program* (May 7, 2012) (online at http://www.fhfa.gov/webfiles/23920/5-7-12_Burns_Final_HFS_Subcommittee_on_Capital_Markets_REO_Testimony.pdf).

- The lack of joint FHFA/FHA assessments of such issues has limited the transparency of their respective pricing initiatives. Consequently, there is a limited basis for Congress, market participants, and the public to assess the implementation of the FHFA and FHA initiatives, their prospects for success, or corrective actions that may be required to ensure their success.

CONCLUSIONS

FHFA's initiative to encourage private sector investment in mortgage credit risk and reduce the Enterprises' currently dominant presence in the housing finance system through periodic guarantee fee increases has the potential to reduce direct taxpayer exposure to mortgage-related losses by spreading risk to private sector participants. However, the initiative also faces trade-offs and complex external challenges that FHFA will have to address to help ensure its prospects for success. As part of its efforts to implement the initiative, FHFA has opportunities to enhance transparency and strengthen communication and interactions with FHA on key issues.

RECOMMENDATIONS

OIG recommends that FHFA, preferably in consultation with FHA, develop definitions and performance measures that would permit Congress, financial market participants, and the public to assess the progress and the effectiveness of its initiative. OIG also recommends that FHFA assess the feasibility of establishing a formal working arrangement with FHA to assess such critical issues as:

- (1) the implementation of their pricing initiatives and prospects for success in achieving their objectives; and, (2) the potential for shifts of mortgage business and risks between government supported or guaranteed markets;
- Briefing FHFOB and/or FSOC on the findings of the assessment; and
- Disclosing the assessment publicly in an appropriate format.

OBJECTIVES, SCOPE, AND METHODOLOGY ....

The objectives of this evaluation were to (1) provide an independent analysis of FHFA's initiative to increase private sector investment in mortgage credit risk and reduce the Enterprises' dominant position in housing finance through gradual increases in their guarantee fees, and (2) assess FHFA's communication and interaction with FHA on their pricing initiatives.

To address this report's objectives, OIG interviewed FHFA officials in the Office of Policy Analysis and Research and the Enterprise Risk Modeling Branch. Further, OIG interviewed Enterprise representatives, including single-family pricing experts, modelers, and model validation staff.

In addition, OIG reviewed Agency publications and documents—such as model examination reports and documents from the Enterprises, including briefing materials on risk-based capital model changes. Moreover, OIG obtained and analyzed historical data on the Enterprises' guarantee fee pricing. OIG also reviewed the 2011 HUD/Treasury white paper on housing finance reform and federal planning standards as discussed in several GAO products referenced in footnotes to this report.

This study was conducted under the authority of the Inspector General Act and is in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which was promulgated by the Council of the Inspectors General on Integrity and Efficiency. These standards require OIG to plan and perform an evaluation that obtains evidence sufficient to provide reasonable bases to support its findings and recommendations. OIG believes that the findings and recommendations discussed in this report meet these standards.

OIG provided FHFA staff with briefings and presentations concerning the results of its fieldwork and provided FHFA an opportunity to respond to a draft report of this study. FHFA provided written comments, which are reprinted in Appendix C, and our evaluation of FHFA's comments is provided in Appendix D. Both FHFA and the Enterprises provided technical comments on report drafts that were incorporated into the final report as appropriate.

APPENDIX A ....

FHFA's Initiatives to Address Cross-Subsidization in Enterprise Guarantee Fee Pricing

As discussed in the body of this evaluation report, FHFA has argued that federal financial support for the Enterprises over the years has allowed them to set their MBS guarantee fees lower than would otherwise be the case. Accordingly, FHFA is in the process of requiring the Enterprises to raise their guarantee fees so that they better reflect potential risks and offset their cost advantages over potential competitors. As part of its recent initiatives, FHFA has also required the Enterprises to raise and adjust their guarantee fees to address the "cross-subsidization" of mortgage products. This Appendix briefly describes guarantee fee cross-subsidization, FHFA efforts to mitigate it, and the potential that FHFA's initiatives are necessary to help ensure the Enterprises' financial soundness.

Definition and Sources of Guarantee Fee Cross-Subsidization

A subsidy is a grant or other financial assistance typically given by the government for the support or development of a business entity. In the case of mortgage financing in the secondary market, federal financial backing provides a significant pricing advantage to the MBS issued, guaranteed, and sold in the capital market by the Enterprises. Enterprise MBS are perceived as a nearly credit risk-free investment regardless of the performance of the underlying mortgages. This has proven to be true even in the event of a severe financial crisis, such as the one that began in 2008. In addition, due to the implicit and explicit government backing, and hence low probability of default, the Enterprises are able to issue debt at a lower rate than a comparable private-sector company. This, in turn, provides the Enterprises a cost-of-capital advantage over their private competitors. Consequently, the Enterprises transmit at least a portion of the resulting funding advantage to MBS investors in the form of reduced guarantee fees.[80]

In addition to the federal support of the Enterprises, which resulted in a lower-than-market rate guarantee fee, the Enterprises have engaged in cross-subsidization across their mortgage pools with different risk profiles. Cross-subsidization refers to the practice of charging higher prices to one group of consumers in order to subsidize lower prices for another group. In the area of mortgage financing and guarantee fee pricing, cross-subsidization occurs when certain higher risk loan pools are subject to relatively lower guarantee fees than

[80] Some of the subsidized rates could also be passed onto homeowners by lenders in the form of reduced mortgage interest rates.

they would pay otherwise given the pool's credit risk profile. The shortfall resulting from the low fees paid on these pools is recouped, or "cross-subsidized," to some degree by the relatively higher fees on MBS backed by lower risk loan pools. Historically, some of the examples of cross-subsidization among Enterprise-insured MBS guarantee fee pricing were:

- MBS collateralized by mortgage pools sold on a cash-basis by smaller lenders to the Enterprises were subsidizing MBS collateralized by mortgage pools sold on a swap-basis by larger lenders to the Enterprises. Prior to 2008, the Enterprises tended to negotiate volume-based guarantee fee discounts to large lenders;
- MBS collateralized by lower risk mortgage products were subsidizing MBS collateralized by higher risk mortgage products.[81] Generally, lower risk MBS mortgage pools were more likely to be comprised of mortgages with 15-year fixed rates, high borrower credit scores, and/or low LTV ratios. Conversely, higher risk mortgage pools were comprised of mortgages with 30-year fixed rates or adjustable-rates, low credit scores, and/or high LTV ratios. Yet, the fees charged by the Enterprises did not fully reflect such risk differences; and
- Mortgages originated in non-judicial foreclosures states were subsidizing mortgages originated in judicial foreclosure states.[82] According to FHFA, judicial foreclosure states tend to have more expensive and protracted foreclosure processes than non-judicial states. Traditionally, in their guarantee fee pricing, the Enterprises have not distinguished between the various geographic locations of mortgage pools nor have they considered state foreclosure laws in pricing decisions.

FHFA Initiatives to Address Cross-Subsidization in Guarantee Fee Pricing in 2012

In 2012, FHFA Required the Enterprises to Take Steps to Reduce Cross-Subsidization Based on Lenders' Sizes and Mortgage Products' Risks

On August 31, 2012, FHFA announced that it had directed the Enterprises to begin implementing its 2012 Conservatorship Scorecard objective of raising single-family guarantee fees. Although the overall weighted-average aggregate increase was expected to be ten basis points for Enterprise mortgages, the actual increase for each MBS pool is expected to vary by product and execution mechanism.

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[81] *See FHFA Guarantee Fee Study*, at 25-38.

[82] The principal difference between the two foreclosure processes is that the judicial procedure requires court action on a foreclosed home, and the non-judicial process does not involve court action. Therefore, the non-judicial process is generally considered to be shorter and less expensive.

As part of its August 2012 directive to raise guarantee fees by 10 basis points, FHFA also required the Enterprises to aim for uniform pricing across all lenders, regardless of their volume of transactions, by applying differential increases for swaps and cash purchases designed to reduce significantly the previous pricing difference between large and small lenders, on average.[83] FHFA said it took this step to help eliminate cross-subsidies between lenders as well as between mortgage products. For example, to add uniformity to the fees the Enterprises charge lenders, the increase would be larger for lenders delivering larger volumes of mortgages than for lenders delivering smaller volumes.

FHFA also announced that the guarantee fee increase for adjustable rate mortgages and loans with maturities longer than 15 years would be greater compared to the increase for 15-year fixed rate mortgages. This adjustment is intended to reduce cross subsidies between higher risk and lower risk mortgage products.

FHFA Has Also Proposed Changes to Guarantee Pricing Based on State Foreclosure Costs

On September 20, 2012, FHFA announced that it was soliciting public comments on its proposal to adjust the single-family mortgage guarantee fees that the Enterprises charge in states where costs related to foreclosure practices are statistically higher than the national average. The size of the fee adjustments in the form of additional upfront fees is intended to reflect the disparity in carrying costs, as compared to the national average.[84]

According to FHFA, this proposal would mitigate the current situation wherein mortgages originated in states with foreclosure costs at the national average or below pay relatively high guarantee fees to subsidize mortgages originated in relatively high cost states. The primary drivers of differences across states in the total carrying costs to the Enterprises of a defaulted single-family mortgage are, according to FHFA, the length of time needed to secure marketable title to the property, property taxes and condo fees that must be paid until marketable title is secured, and legal and operational expenses incurred during that period.

FHFA received 60 comment letters in response to its solicitation. Many of them, including letters from members of Congress, state attorneys general, and major trade organizations, sought transparency in FHFA's calculations of carrying costs and foreclosure time frames. Respondents also criticized the proposal's potential impact on low-income borrowers and

[83] *See* FHFA, *FHFA Announces Increase in Guarantee Fees, G-fee Report for 2010-2011 Released* (August 31, 2012) (online at http://www.fhfa.gov/webfiles/24259/Gfee083112.pdf).

[84] The proposal would result in increased upfront guarantee fees of between 15 and 30 basis points for 5 states: Connecticut, Florida, Illinois, New Jersey, and New York. For more information, *see* FHFA, *State-Level Guarantee Fee Pricing*, 77 Fed. Reg. 58991 (September 25, 2012) (online at http://www.fhfa.gov/webfiles/24525/NoticeStateLevelGfees_to_Fed_RegFINAL.pdf).

the housing recovery in the five covered states and its failure to account for other factors affecting foreclosure timelines and costs, such as servicer deficiencies. Alternatively, several trade organizations commended FHFA's attempt to reduce Enterprise costs by assessing higher fees to mortgages in states that represented statistical outliers.[85] The Agency has yet to act on its proposal but officials told OIG that a decision would be reached in 2013.

FHFA's Guarantee Fee Cross-Subsidization Initiatives Likely Have Important Ramifications for Ensuring the Enterprises' Financial Soundness

FHFA's initiatives to address cross-subsidization (i.e., raising guarantee fees to account for different risk characteristics) likely has important ramifications for ensuring the Enterprises' financial soundness. According to Enterprise officials, their internal analysis indicates that recent guarantee fee increases are nearing sufficient levels to encourage private sector financing of relatively lower risk mortgage products, such as those with low LTVs and high credit scores. On the other hand, their analysis also indicates that guarantee fees would need to rise considerably higher to attract private sector interest in higher risk mortgages.

Thus, as FHFA requires the Enterprises to increase gradually guarantee fees overall to attract private sector investment in mortgage credit risk there is a potentially significant risk of what is known as "adverse selection."[86] That is, the private sector could conceivably capture a significant share of the Enterprises' lower risk mortgage business leaving them with an increasing share of higher risk mortgage assets. Under such a scenario, the Enterprises potentially could incur significant credit losses.

However, FHFA officials said that the cross-subsidization initiative mitigates the adverse selection risk by ensuring that guarantee fees appropriately reflect the risks of all types of Enterprise mortgage assets. Additionally, with guarantee fee increases concentrating on higher risk mortgage loans, the potential returns (or profits) on higher risk mortgage assets may soon prove attractive to private sector market participants. Thus, private sector

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[85] *See* FHFA, *Regulations, Notices, Public Comments and Input, 9/25/2012 State-Level Guarantee Fee Pricing* (77 FR 58991) (online at http://www.fhfa.gov/Default.aspx?Page=89) for the comments of the American Bankers Association; the Association of Mortgage Investors; the Attorneys General of Illinois, Connecticut, and New York; the Credit Union National Association; Members of Congress; the Mortgage Bankers Association; the National Association of REALTORS; and the National Council of State Housing Agencies, among others.

[86] "Adverse selection" is a term used in economics, insurance, and risk management. It refers to a market process in which undesired results occur when buyers and sellers have asymmetric information and, as a result, bad products or services are more likely to be retained. For example, in the insurance market, an insurance agent has less information on the risk levels of its customers than the customers themselves; therefore, by not pricing its service commensurate with different risk levels, only higher risk customers would purchase the insurance.

participants may compete with the Enterprises for such mortgage assets and the Enterprises may not necessarily be left with guarantee obligations weighing more heavily toward higher risk mortgages. Although FHFA's cross-subsidization initiative may achieve this objective, the initiative is still ongoing and it remains to be seen how effective it will be.

APPENDIX B..

FHFA's Initiatives on Mortgage Credit Risk Sharing Transactions

In addition to the guarantee fee increase initiative discussed in the body of this report, FHFA is exploring other methods by which to reduce the credit risks to the taxpayers inherent in the operations of the Enterprises. Specifically, in its 2013 Conservatorship Scorecard, FHFA proposes that the Enterprises enter into risk sharing transactions covering $30 billion of unpaid principal balances from single-family mortgages.

One Enterprise official informed OIG that the Enterprise first delved into risk sharing proposals about two years ago, and by early 2012 FHFA had endorsed the idea and directed the other Enterprise to join preparatory work to lay the foundation for executing risk sharing transactions in 2013.

FHFA officials said that the Agency has specified that each Enterprise must conduct multiple types of risk sharing transactions to meet the 2013 target. FHFA's 2013 Scorecard encourages the Enterprises to consider, among others strategies, the following:

- Expanding mortgage insurance with qualified counterparties. FHFA's Acting Director has stated that FHFA will implement new eligibility standards for private mortgage insurers;
- Issuing credit-linked securities. A credit-linked note is a form of derivative that contains an embedded credit default swap that permits the issuer (an Enterprise) to transfer a specific credit risk to its investors;
- Issuing senior and subordinated securities. A subordinated note is debt that ranks after senior debts should an adverse event occur. Subordinated debt typically has a lower credit rating and, therefore, a higher yield than senior debt; and an investor who purchases a subordinated note assumes the credit risk in return for a higher yield;
- Seeking risk retention with lenders through lender recourse agreements; and
- Using other risk sharing counterparties, such as reinsurance companies, to leverage credit risks.

FHFA stated that the goal for 2013 is to move forward with these transactions and to evaluate the pricing and the potential for further execution in the future.

APPENDIX C...

FHFA's Comments on OIG's Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker
FHFA-OIG Director of the Office of Policy, Oversight, and Review

FROM: Sandra Thompson
Deputy Director, FHFA Division of Housing Mission and Goals

SUBJECT: Comments on the FHFA-OIG draft evaluation report "FHFA's Initiative to Decrease the Enterprises' Dominant Position in the Housing Finance System by Raising Their Guarantee Fees"

DATE: June 26, 2013

We appreciate the opportunity to respond to OIG's draft evaluation report titled "FHFA's Initiative to Decrease the Enterprises' Dominant Position in the Housing Finance System by Raising Their Guarantee Fees." Our response to the two recommendations of the report are as follows:

Recommendation 1. *Preferably in coordination with FHA, develop definitions and performance measures that would permit Congress, financial market participants, and the public to assess the progress and the effectiveness of FHFA's initiative.*

Management Response: It is our view this recommendation has been previously addressed. Publicly, we have explained our guarantee fee actions, and provided reasons supporting the agency's strategy and actions. Increasing guarantee fees moves Enterprise credit risk pricing closer to levels private capital holders would require.

Pricing risk at market levels is ultimately intended to attract private capital into mortgage markets - capital will not be willing to reenter the market until guarantee fees have reached sufficient levels to offset credit risk.

Further, FHFA's statutory responsibility to conserve assets compels us to move toward full market pricing for all services provided by the Enterprises. We have purposefully paced guarantee fee increases to be gradual, in efforts to prevent undue shock to a still-fragile and recovering housing market.

Our goal is a regular and increasing flow of new mortgage securities backed by quality loans that could have been sold to an Enterprise but which are not guaranteed by either the Enterprises or a government agency. At this point, we have seen a small scale birth of a new issue market for mortgage securities backed by newly originated loans. We do not have a fixed quantitative target, but intend to monitor market conditions closely. We have also stated publicly that initiating risk-sharing transactions, which will begin shortly, will also provide us with useful information on market pricing of credit risk.

Recommendation 2. *Assess the feasibility of establishing a formal working relationship with FHA to communicate and collaborate on our respective pricing initiatives.*

Management Response: We disagree with this recommendation's suggestion that we establish a formal working relationship with FHA to collaborate on pricing initiatives. It is our view, the Housing and Economic Recovery Act of 2008 (Pub.L. 110–289, 122 Stat. 2654, enacted July 30, 2008) (commonly referred to as HERA) created FHFA as an independent agency with specific statutory responsibilities. Consequently, we believe an informal approach to working with other federal regulatory agencies is more appropriate.

We communicate frequently with other agencies about common concerns and issues. As you noted in the draft report, we have communicated about Enterprise single-family guarantee fees with the Department of Housing and Urban Development (HUD) through meetings of the Federal Housing Finance Oversight Board and through direct interactions with the Federal Housing Administration (FHA) and Ginnie Mae. We strongly believe an independent approach to price determination for the Enterprises is appropriate for our Agency.

We have taken into consideration a number of factors, including the potential effect of price changes on the relative business volumes of FHA and the Enterprises. FHA pricing structures are quite different from those of the Enterprises (for instance, FHA has uniform pricing for all borrowers), and lenders' decisions about where to send most loans are not especially sensitive to Enterprise price changes.

Lastly, FHFA has a statutory responsibility to conserve Enterprise assets. As you noted in the draft report, Enterprise guarantee fees were underpriced historically, and increasing the fees is critical to move toward compensating taxpayers, who support the Enterprises, adequately for credit risk. Neither HUD nor FHA shares that objective, because those agencies do not have the same responsibility by statute as FHFA. Consequently, while we will continue to ensure regular communication with those agencies, formal collaboration on Enterprise and FHA pricing decisions is unnecessary.

APPENDIX D ....

OIG's Response to FHFA's Comments

FHFA did not accept our recommendations (*see* Appendix C containing the FHFA management response). Our recommendations, therefore, remain open and we will continue to monitor the issues discussed herein. Our specific response to FHFA's management comments is as follows.

Recommendation One

We recommended that FHFA develop definitions and performance measures for its initiative to raise the Enterprises' guarantee fees as a means to increase private investment in mortgage credit risk. FHFA management responded by asserting that the recommendation had been "previously addressed," and then reiterated the general objectives of its initiative.

However, as discussed in our report, we do not believe FHFA has adequately addressed the issue to date. Further, the report identifies several options available to FHFA that could serve as definitions and performance measures for its initiative to increase private investment in mortgage credit risk. Additionally, in its management comments, FHFA notes that it has "seen a small scale birth of a new issue market for mortgage securities backed by newly originated loans;" the Agency could commit to using such data in its public planning documents as a measure of private sector participation in mortgage credit risk, tracking it over time and, perhaps, establishing percentage thresholds as indicators of private mortgage investment.

Recommendation Two

FHFA disagreed with our recommendation that it assess the feasibility of establishing a formal working arrangement with FHA, citing its status as an independent agency with specific statutory authorities. FHFA said that its informal approach to working with other agencies is "more appropriate" than a formal approach.[87]

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[87] In response to FHFA's comments, we made limited revisions to the text of the report and the recommendation to specify that we believe the Agency should seek to establish more formal working arrangements with FHA to assess key issues involving their pricing initiatives. We do not believe these limited revisions changed the substance of the recommendation in the draft report originally provided to FHFA. In particular, the original recommendation focused on FHFA and FHA jointly assessing key issues as does the revised recommendation.

Our recommendation is neither inconsistent with FHFA's status as an independent agency nor with its practice of working in formal arrangements with other governmental entities. In this regard, we observe that FHFA engages in formal interactions on other critical housing finance and safety and soundness issues with a range of federal agencies through its statutorily mandated roles as Chair of the FHFOB and as a member of FSOC. We further observe that FHFA has stated publicly that in 2011 and 2012 it successfully participated in a formal working group with HUD and other federal agencies that developed a pilot program under which foreclosed Fannie Mae properties were sold in bulk with rental commitments.

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