Testimony of
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House Committee on Financial Services
Subcommittee on Housing & Insurance

Hearing Entitled:
"The Current Mortgage Market: Undermining Housing Affordability with Politics"
Wednesday, May 17, 2023

Chairman Davidson, Ranking Member Cleaver, and Members of the Subcommittee:

Thank you for the invitation to participate in today's hearing. I am here on behalf of the Housing Policy Council, a trade association comprised of the leading national mortgage lenders and servicers, mortgage, property, and title insurers, and technology and data companies. HPC's members share a common interest in the safety and soundness of the housing finance system, the equitable and consistent regulatory treatment of all market participants, and the promotion of lending practices that create sustainable homeownership opportunities in support of vibrant communities and long-term wealth-building for families.

The topic of the hearing is the Federal Housing Finance Agency's January announcement updating the pricing of upfront fees for certain mortgages sold to the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), also known collectively as the Enterprises or the GSEs. That announcement has stirred a useful debate about the government's role in setting the price of mortgage credit. In my statement, I hope to provide insights on the issues involved and to offer HPC's perspective on the relationship between pricing, capital, risk to investors and taxpayers, safety and soundness, and expanding homeownership opportunities.

Critical Context – The GSEs Have a Single Purpose with Specified Targets

Congress created Fannie Mae and Freddie Mac and established their unique corporate charters. Those charters require the two companies to meet essentially identical purposes:

- Provide stability in the secondary mortgage market;
- Respond appropriately to the private capital market;
- Provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and
- Promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.[1]

Congress also created the Federal Housing Finance Agency (FHFA) in 2008 to be both the safety and soundness regulator for Fannie Mae and Freddie Mac and their mission regulator.[2] I served as the Acting Director of FHFA from 2009 to 2014. As a safety and soundness regulator, Congress gave FHFA an extensive set of responsibilities and authorities for setting risk-based capital requirements and supervising the prudential operations of the companies. Congress also assigned FHFA responsibility for setting affordable housing goals and duty to serve requirements for the companies.

[1] The third and fourth purposes listed are further developed in their charters in the context of meeting affordable housing goals and satisfying duty-to-serve requirements. These purposes are tied to those requirements. 12 U.S.C. §1451 Note (Freddie Mac), 12 U.S.C. §1716 (Fannie Mae).

[2] The Housing and Economic Recovery Act of 2008 (P.L. 110-289) amended the Federal Housing Enterprise Financial Safety and Soundness Act of 1992 (12 U.S.C. §4501 et seq.) to establish FHFA as the safety and soundness regulator and the mission regulator for the GSEs. Before 2008, the Office of Federal Housing Enterprise Oversight was the safety and soundness regulator for the GSEs, and the Department of Housing and Urban Development was the mission regulator for the GSEs.

The statutory purposes of Fannie Mae and Freddie Mac combined with FHFA's statutory responsibilities and authorities indicate that Congress expects the two companies to advance the stability and availability of mortgage credit across all markets and incomes while operating in a safe and sound manner as private financial institutions in a housing finance system supported by private capital. In other words, Fannie Mae and Freddie Mac have a mandate to facilitate and support the liquidity of the secondary mortgage market. In doing so, Congress specified that the companies operate as safe and sound private financial institutions that need to hold adequate capital and manage risk. *Accomplishing this purpose directly enhances the availability of mortgage credit throughout the country and lowers the cost of such credit to homebuyers*. Congress went a step further and instructed that Fannie Mae and Freddie Mac take specific steps and meet specific goals to expand mortgage credit availability in identified geographies and for low- and moderate-income families.

On January 19, 2023, FHFA announced a series of changes to the upfront fees applicable to certain single-family mortgages sold to Fannie Mae and Freddie Mac.[3] These upfront fees are one-time payments made by lenders to the GSEs when a loan is acquired by one of the GSEs and are a critical component of maintaining a safe and sound housing finance system. They serve the purpose of compensating the GSEs for providing a credit guarantee on a mortgage security and conveying important information to consumers about the riskiness of a loan they may undertake. Underpricing mortgage credit risk was a direct and significant contributing factor to the 2008 insolvency of both companies and the broader housing crisis. Thus, these upfront fees may be credibly considered one of the post-crisis reforms put in place to help safeguard the safety and soundness of Fannie Mae and Freddie Mac and the broader economy.

For purposes of today's discussion, I will divide FHFA's most recently announced pricing changes into two buckets. First, there are the adjustments FHFA made to the pricing grids that establish the upfront fees. Second, FHFA introduced, then rescinded, a new upfront fee adjustor based on the borrower's debt-to-income (DTI) ratio.

There is nothing new or novel about the pricing grids. According to FHFA, the recently announced changes were an effort to more accurately reflect the risk of borrowers based on their credit risk profile and to align with changes made in 2020 capital rules. The result lowered the fees for some borrowers and raised them for others. Most of the changes were modest in size. One effect of these changes has been that many of the highest risk borrowers realize a reduction in such fees and certain moderate-risk borrowers realize an increase. These changes have provoked much debate in recent weeks, with reasonable people taking different positions on the appropriateness of the changes.

The new DTI-based pricing element has received less attention but was immediately a major concern for HPC members. It was an unexpected addition that created unintended problems for both lenders and borrowers.

Summary of HPC's Views

The DTI pricing element was unworkable and had negative consequences for borrowers.

The new DTI-based pricing element required higher fees for borrowers with debt-to-income ratios greater than 40 percent. DTI, however, is difficult to measure and can change throughout the

[3] https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Updates-to-Enterprises-SF-Pricing-Framework.aspx

underwriting process. As a result, the inclusion of the DTI element in the pricing grids could cause a borrower's loan pricing to change multiple times before loan closing, resulting in multiple loan disclosures and borrower confusion.

Given the operational challenges associated with calculating DTI and the negative consequences for borrowers, HPC and others asked FHFA for an implementation delay during which lenders could review the operational challenges posed by the change. FHFA granted that extension, but after additional evaluation, HPC concluded the proposed pricing element simply was not workable. We sent a detailed letter to FHFA on April 28th outlining our reasons for this conclusion. That letter is attached to this statement.

On May 10th, FHFA announced that it was rescinding the DTI-pricing element. In its announcement, FHFA specifically cited the feedback it had received from industry and from other stakeholders. HPC is grateful for this reconsideration and for FHFA's willingness to consider relevant feedback on its actions.

The adjustments to the pricing grids appear reasonable, but pricing should be aligned with credit risk and capital requirements.

In contrast to the operational challenges posed by the DTI-based pricing element, the other adjustments to the pricing changes announced in October 2022 and January 2023 have been relatively easy to implement because the framework itself – loan level fees based on credit score and loan to value ratio – are part of each lender's loan origination process. The debate that has emerged over these adjustments relates to the appropriateness of the size and direction of the changes. In other words, the pricing adjustments raise policy questions, not operational ones.

HPC's position on these pricing adjustments is that the upfront fees and the other on-going fees charged by the GSEs (collectively "guarantee fees") should align with borrower credit risk and be consistent with how such risk is factored into risk-based capital requirements. Manipulating these fees in a way that misaligns pricing and risk or pricing and capital requirements is not a constructive way to advance safety and soundness or to promote sustainable access to mortgage credit.

Since the purpose of the upfront fees is to provide a risk-based component to guarantee fees, it makes logical sense for these fees to be based on risk. To do otherwise risks serious distortion in the cost of mortgage credit, which can result in detrimental outcomes such as inflated house prices and unstable markets. Indeed, the severe mispricing of mortgage credit risk in the runup to the Great Recession was a root cause of that disaster. Furthermore, as I explain later in my testimony, the last time Congress explicitly addressed guarantee fees, it recognized the importance of aligning pricing with risk.

As for the recent changes, they appear to be reasonably aligned with credit risk after accounting for the new capital framework, the cost of private mortgage insurance, and recognition that the riskiest cells in the grid represent very few Enterprise purchases. That said, only FHFA has the detailed data and models to explain fully how the grids align with risk and the recently finalized risk-based capital framework. This opacity has proven to be controversial and therefore, HPC and its members recommend increased transparency from FHFA regarding the pricing across the risk categories, relative to the capital standards.

While market participants often seek to moderate price adjustments as risk increases to avoid dramatic gradations in pricing, increasing the price of credit as risk increases is a sound principle. It is also a necessary one to ensure the efficient allocation of capital and the stability and the safety and soundness of our financial system.

If market pricing produces a sub-optimal allocation of credit to certain categories of borrowers, there are better, and more effective, policy responses. In spite of the statutory allowance for affordable housing goal loans realizing lower rates of return than the rest of the business, pricing should not be deployed to promote or advance the affordable housing mission activities of the GSEs (especially when used to directly subsidize higher risk borrowers). There are more direct, and more effective, means for promoting homeownership than inducing more risk for borrowers and the secondary mortgage market.

In the balance of my statement, I provide some background on guarantee fees and their relationship to risk and on broader but related policy issues.

History, Objective and Structure of Guarantee Fee Pricing

What is a Guarantee Fee?

When Fannie Mae and Freddie Mac purchase a mortgage loan from a lender, the price they pay is a function of mortgage interest rates and the guarantee fee (g-fee). Mortgage interest rates are determined in global capital markets based on a variety of factors including the supply and demand for residential mortgage-backed securities (MBS). The g-fee charged by Fannie Mae and Freddie Mac is used to compensate those companies for:

- Expected and unexpected losses associated with the credit guarantee they provide to MBS investors, which repays the MBS investor the full principal balance should a borrower default on a mortgage loan that collateralizes the MBS;
- the company's operating costs, and
- a return on capital.

G-fees have two components: base g-fees and upfront fees. Base g-fees are expressed in basis points and embedded in the mortgage rate. The base g-fees are not aligned with borrower risk, although they may vary by product type. According to FHFA's most recent report to Congress on g-fees, the average base g-fee currently charged by the GSEs is 43 basis points. [4]

Upfront fees are assessed at the loan level based on borrower risk characteristics. They are priced in basis points and assessed against the loan balance. Determining how the upfront fee relates to the interest rate the borrower pays on a mortgage requires a calculation that reflects prepayment probabilities. As a general rule, dividing the upfront fee by four-to-six (FHFA used six in its November 2022 g-fee report)[5] provides an estimate for how the upfront fee translates into the borrower's interest rate. The average upfront fee reported in the most recent FHFA report to Congress is 13 basis points when converted into an interest rate equivalent. This makes the total average g-fee 56 basis points or

[4] The Director of FHFA is required to submit an annual report to Congress on g-fees, which includes a description of: (1) changes made to up-front fees and annual fees as part of the guarantee fees negotiated with lenders; (2) changes to the riskiness of the new borrowers compared to previous origination years or book years; and (3) any adjustments required to improve for future origination years or book years. (12 U.S.C. §4547(d)). The most recent annual report was released in November, 2022: "Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2021", November, 2022. https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GFee-Report-2021.pdf

[5] Ibid. Footnote 5.

just over one-half percent in mortgage rate.[6] In other words, the average upfront fee is just 23 percent of the total g-fee.

The History of Guarantee Fees Relative to Capital Standards

Prior to 2008, the two GSEs did not engage in loan-level risk-based pricing. Both companies collected guarantee fees from sellers for the delivery of loans, but did not charge an upfront fee or vary the guarantee fee based on the risk characteristics of the loan. As already noted, guarantee fees at this time fell well short of a level commensurate with the actual credit risk assumed by the GSEs. Furthermore, FHFA's predecessor agency was constrained by statute to implement an inadequate statutory capital standard enacted in 1992. Further, prior to 2008, the g-fees charged by the GSEs were not uniform for all lenders. Favorable pricing was offered to lenders that delivered a high volume of loans, regardless of risk profile.

In March 2008, to stabilize the companies' finances, the companies introduced two upfront fees, one an adverse market fee of 25 basis points for all loans and the other an upfront fee based on two determinative risk variables, borrower credit score and loan-to-value ratios.[7] In September 2008, the GSEs failed and were placed into conservatorships by their new regulator, FHFA.

When Congress created FHFA, it gave the agency greater authority over the capital requirements for the GSEs, including the authority to impose risk-based capital requirements. Regulatory capital requirements are a basis for assessing the amount of g-fee needed to achieve a target return on equity. The Enterprise Regulatory Capital Framework (ERCF), established in 2020, is supposed to be the basis for the capital component of that pricing determination. However, FHFA's most recent g-fee report to Congress still reflects the Conservatorship Capital Framework (CCF) established in 2017, as the GSEs move to full adoption of the ERCF in 2022.[8] The ERCF capital standards are substantially higher than the 2017 framework and HPC supported the introduction of the ERCF standards, including the modifications subsequently made by Director Sandra Thompson to restore capital credit for credit risk transfer (CRT) transactions.

The fundamental purpose of the ERCF is to direct the GSEs to maintain a sufficient level of capital to compensate for the risks that arise in the operations and management of the companies. Capital standards are a traditional and proven safety and soundness tool for financial regulators, and the ERCF is based on a comprehensive analysis of the risk characteristics of each GSE's book of business and the appropriate levels of capital that must be available to address credit, market, and operational risk exposure, in both normal economic conditions as well as periods of market stress. In turn, GSE pricing is designed to generate sufficient revenue to cover the modeled risk of loss, ensure the companies satisfy these capital requirements, and earn a target rate of return.[9]

FHFA's annual g-fee reports to Congress present an aggregated view of how current g-fees affect GSE profitability by loan, borrower, and lender characteristics. The reports illustrate the performance of various segments of the GSEs' credit guarantee business relative to a target rate of return. As the reports illustrate, various types of loans exceed, meet, or fall short of the targeted return on regulatory

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[6] Ibid. Page 2.
[7] Ibid. Page 12.
[8] Ibid.
[9] While the GSEs remain in conservatorship, they continue to rely upon taxpayer support to satisfy their capital requirements.

capital. A negative gap does not mean that the GSE sustains a loss on those loans but rather that those loans are expected to earn below the target rate of return on capital. An example of loans where the GSEs intentionally receive a lower-than-target rate of return are mortgages that satisfy the affordable housing goals. Regardless, the GSEs are expected to earn at least the target rate of return on capital for their full books of business. The g-fee reports do not indicate what segments, if any, of a GSE's book of business actually operates at a loss.

As noted above, the most recent g-fee report (November 2022) is calibrated to the old CCF, because the ERCF did not take effect until 2022. Therefore, the gaps between the revenue generated and an ERCF rate of return are not yet available. Regardless, we can surmise that the old g-fee grid was not commensurate with the new ERCF.[10]

Pricing to Achieve Both Target Rate of Return and Risk Management- Practices to Minimize Risk

Ultimately hitting the target rate of return requires the GSEs to price their loans at a level that will generate the revenue required to fully satisfy the ERCF. This means that pricing must adequately cover the risk of loss, expected and unexpected, with earnings sufficient to hit the target rate of return on capital. Using g-fee pricing to advance other objectives, such as subsidizing high-risk borrowers, runs counter to prudent risk management. In other words, pricing to achieve a target rate of return is essential to compensate for risk of loss that cannot be eliminated or mitigated through the GSEs' underwriting, which is intended to minimize the frequency or likelihood of borrower default, and loss mitigation programs, which moderate the severity of losses for those loans that do default.

To be more precise, absent the first loss risk absorbed by private mortgage insurers, the GSE underwriting standards serve as the primary means to control and contain the amount of risk (i.e., level of defaults) that each GSE is willing and able to bear. The risk to be contained is associated with the borrower, the property that will be the collateral for the mortgage, and the transaction terms. The credit characteristics of the borrower include: a) ability to repay the mortgage; b) past history in satisfying financial obligations; and c) cash available for a downpayment and reserves once the transaction is completed. The value of the property, which may be needed to repay the loan should a borrower default, determines the allowable size of the loan. And, finally, the terms of the loan, such as how quickly it will amortize, affect the overall risk profile of the mortgage transaction.

The GSE loss mitigation programs are designed to reduce the severity of losses to the GSEs. These programs allow a borrower in financial distress to suspend or miss payments, then recover and reperform or pay off the loan by surrendering or selling the collateral. The recovery could include resolving the arrearages through some form of immediate or deferred repayment or by restructuring the loan. Should the borrower be unable to resolve the missed payments, the property may be sold or transferred to pay off the outstanding indebtedness. Any of these measures will cost the GSEs less than

[10] According to FHFA: "The transition to the ERCF will have important implications for returns and profitability gaps. Higher capital requirements and flatter risk gradients in the ERCF compared to CCF result in a lower and flatter return profile and profitability gap profile across the credit risk spectrum. Returns on loans with lower credit risk characteristics under the ERCF will be considerably lower compared to CCF and returns on loans with higher credit risk characteristics will be notably lower compared to CCF." See the November 2022 G-Fee Study, page 9.
https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GFee-Report-2021.pdf

a foreclosure, thus reducing the severity of their losses (and the adverse impact on households and neighborhoods).

Risks of loss that cannot be minimized or mitigated through underwriting or loss mitigation must be covered by the loan pricing. Between the base g-fee and the loan-level pricing via upfront fees, the GSEs must generate sufficient revenue to compensate for these losses. The pricing is the lever that supports and reflects the risk management determinations and practices of the GSEs. It is not a risk management tool itself but is the mechanism that must be calibrated relative to the GSE appetite for and ability to manage risk through underwriting or loss mitigation.

Common Misconceptions Regarding Pricing for Risk and Reaching Traditionally Underserved Borrowers

Given some of the recent commentary relating g-fee pricing to support for the GSEs' housing mission, this section provides HPC's perspective that g-fee pricing should support risk management and safety and soundness and that other tools are best used to promote homeownership.

The Benefits of Risk-Based Pricing for Consumers

There are significant consumer benefits associated with risk-based pricing. Foremost, risk-based pricing provides consumers with a clear signal of the relationship between risk and what they will pay. Reliable information on the relative riskiness of a major financial transaction like a mortgage can positively influence consumer actions, providing incentive for consumers to reduce their risk to qualify for a mortgage loan at a better rate.

Second, historical analysis shows that some lower-income households are advantaged by risk-based pricing. Many lower-income households do not have low credit scores, and without risk-based pricing, these lower-income households (amongst those borrowers who actually pay fees) would subsidize higher-income homebuyers and homeowners with weak credit performance. In short, it is a mistake to simply equate credit score with income.

Third, even with risk-based pricing, GSE pricing continues to provide cross-subsidization of higher risk borrowers by lower risk borrowers, as evidenced by more than a decade's worth of FHFA g-fee reports to Congress.

Finally, in October 2022, FHFA excluded the affordable housing loans from the upfront loan-level pricing adjustors. These loans are subject only to the base g-fee. This means that *if* FHFA removed the upfront fees for *all* borrowers, those borrowers with affordable housing loans likely would pay more than they do under today's pricing framework. This is because the g-fees would need to be increased across-the-board to accommodate for elimination of the loan-level pricing; overall g-fees would go up, an outcome that runs counter to the arguments for removal of the loan-level pricing.

The Role of Private Mortgage Insurance

The media attention and coverage on the new pricing grids most often ignored the role of private mortgage insurance. From the consumer's perspective, the cost of credit protection on their loan is the sum of their MI premium and total g-fees. Thus, to understand the full price to a consumer, the MI price should be added to the GSE fees. Similarly, to understand the actual risk of various lower down payment loans to the GSEs, the extent of mortgage insurance protection must be considered.

MI is one of the permitted forms of credit enhancement that is statutorily required for all mortgages with loan-to-value (LTV) ratios greater than eighty percent. In operation, the amount of MI credit protection to the GSE increases as the LTV increases and the insurance premium for that coverage also increases. That is, very low down payment mortgages usually have much deeper MI protection than mortgages with moderate down payments.

When overlaid on the GSE grids, the combined g-fee plus MI payment for a given credit score increases as LTV increases. What is most important about the MI coverage, however, is the recognition that It represents private capital standing in front of the GSEs. The mortgage insurers take the first loss risk position, accepting losses that would otherwise be borne by the GSEs. Further, the private mortgage insurers core business is pricing and managing mortgage credit risk associated with lower down payment mortgages and they provide another level of risk management. MIs put their own capital at risk and thus perform their own underwriting to verify and affirm the acceptability of the loan for delivery to the GSEs. This type of redundant risk management enhances the safety and soundness of the GSEs and the housing finance system.

Reaching the Underserved

The best way to produce sustainable homeownership for traditionally underserved borrowers is <u>not</u> reduced pricing or more lenient underwriting, both of which increase risk and the cost of losses. Rather than ignoring the risk or accepting the risk and compensating for it by charging all borrowers more, the government would better serve these borrowers with forms of assistance that lower their risk. This support should take the form of assistance funds or subsidies that help a borrower meet the applicable underwriting standards. For example, funds could be used to create reserve accounts or to provide equity into the transaction, both of which would improve the borrower's risk profile. Another idea would be to encourage borrowers to shorten the term of their mortgage, which would result in a faster build-up of homeowner equity. I have testified before this Committee on these ideas before and an excerpt from that testimony is attached to this statement.

Current Methods for Promoting the Housing Mission Lack Transparency and Are Poorly Targeted

HPC and its members credit FHFA for being clear in stating their intention with the various pricing changes made last year and this year. The most recent announcement was previewed in the November 2022 g-fee study and in the conservatorship scorecard. Yet despite all that, the recent debates about g-fees demonstrates that significant confusion remains among stakeholders, regarding both the magnitude of subsidies and related performance outcomes associated with the pricing framework, particularly as it is used to promote the housing mission Congress assigned the GSEs.

Of note, the annual g-fee reports fail to specify the target return on equity used to determine what portions of the book are above or below that target. At a minimum, market participants and other stakeholders would be much better informed if FHFA would disclose two key facts in its g-fee studies. First, what is the target return on equity that determines whether reported g-fee gaps are positive or negative. Second, while FHFA reports loan characteristics that produce a negative gap (that is, fails to earn the target return on equity), readers do not know whether the GSEs expect to generate a profit or a loss on those loans. Are the expected returns positive but below the target, or are the GSEs actually losing money on particular segments of their business?

HPC and its members would also like to point out that this entire discussion of g-fees reflects how poorly targeted the pricing framework is for accomplishing the GSEs' housing mission. Congress established the GSE mission goals to advance certain affordable housing priorities. This g-fee discussion points out that the GSEs are earning above target returns on certain aspects of their business and using that revenue to subsidize the rate on other, generally riskier, portions of the business. It is unknown how much of the revenue actually benefits the targeted households rather than simply being absorbed by other parties to the transaction, creating "leakage" of the intended cross-subsidization benefit to the consumer. HPC members believe such leakage is meaningful.

There would be far greater transparency of how much financial support actually reaches low- and moderate-income families and communities if the subsidy was directly allocated to those borrowers, not embedded in the price a GSE charges the lender. For example, suppose the elimination of upfront fees on goals loans cost the GSEs $10 million in revenue relative to what a risk-based pricing schedule would produce. That is the subsidy. Now suppose that $10 million subsidy was transparently allocated to a pool of funds used to directly assist targeted borrowers. Perhaps the funds go to down payment assistance, or building borrower reserves, or credit repair activity. Then everyone could see how much is spent, who received the support, and how the mortgages performed over time. Surely such a system would be far more accountable than the complicated and opaque structure we have today.

An Important Price Distortion That Needs Attention

Under the statutorily-mandated affordable housing goals and the associated FHFA mandates, the GSEs are expected to purchase a specified mix of so-called housing goal loans. Several of these goals are associated with loans made to low-income and very-low-income persons. As a practical matter, however, the current target level of affordable loans materially exceeds what the market is capable of producing, given today's market conditions. That is, the number of affordable housing transactions in the market fall short of the goals.

As a result, there is a bidding war for these loans but there is no mechanism to ensure the homebuyer benefits. Moreover, competition between the two GSEs over goals loans does nothing to expand the number of borrowers reached. The GSEs are direct participants in such bidding wars in two ways. First, they use their own cash window to compete against loan aggregators, pricing loans at a level that is not commensurate with the risk. Second, they penalize loan sellers for delivering too many non-goals loans. Such penalties come in the form of pricing penalties and limits on non-goals loans the GSE will purchase. In other words, each GSE is incentivizing a given loan seller to sell its affordable loans to them and to sell their other production to the other GSE in order to make the GSE's goals numbers look better.

This is unsustainable. It distorts the market and the deadweight losses it produces do not benefit affordable housing. As one HPC member put it to me, "this unintended consequence turns the goals into merely a math exercise without a benefit to additional borrowers."

Larger Policy Questions for Congress

The recent public discussion of g-fee pricing highlights two larger public policy challenges that are fully appropriate for this committee to consider.

Congress Has Provided FHFA Limited Direction on Pricing – Fortunately, that Direction Encourages Pricing to Reflect Borrower Risk

Congress has given only limited guidance to FHFA in setting g-fees as conservator. In 2011, Congress amended the Housing and Community Development Act of 1992 by inserting a new Section 1327 that required the Director of FHFA to increase the guarantee fees charged by the Enterprises to cover projected tax revenue losses associated with a payroll tax cut.[11] More specifically, Congress directed FHFA to increase g-fees by an average of 10 basis points and remit those proceeds to Treasury. Congress further directed that the increase be implemented within two years and "provide for adjustments in pricing based on risk levels." In other words, Congress has explicitly recognized the importance of aligning pricing and risk.

Absent further Congressional direction, and so long as the GSEs remain in conservatorship, FHFA should periodically review and update the g-fees. In doing so, it should be motivated to align pricing with risk.

Lessons for Housing Finance Reform

HPC believes that restoring a commercial market setting discipline, for both capital and pricing, in the secondary mortgage market requires Congressional action. The current debates over FHFA's recent announcements highlight one of the shortcomings of utility model proposals. Namely, such models put a government entity like FHFA right back in the center of making pricing decisions over mortgage credit risk.

The mortgage market is inherently cyclical and interest rates themselves can move quickly and substantially, as we have recently witnessed. Regulated price-setting mechanisms will never keep up. If we want private capital to absorb risk, pricing and capital rules need to align with risk. If a market-based system produces a sub-optimal allocation of credit or number of homeowners from a public policy perspective, then that should be addressed directly by government programs and subsidies, not by manipulating how we price mortgages for default risk.

Concluding Remarks

In 2008, Congress created FHFA and gave it authority to appoint itself as conservator or receiver of Fannie Mae and Freddie Mac. It did not give FHFA authority to fund such actions. Instead, it gave the funding authority to Treasury. And the only authority Congress gave FHFA with regard to putting a company in receivership was to re-issue the exact same charter with the exact same corporate name, authorities, and so on. In other words, FHFA cannot combine the two companies, create more of them, or change the terms of their corporate charters, terms that ultimately contributed to their failures in 2008. Other limitations of the ongoing conservatorships are limitations on independent business decision-making across a spectrum of issues ranging from pricing to strategic plans to business development to compensation.

As conservator, the FHFA Director stands in the shoes of the boards and senior management of the conserved companies. While the conservator's authorities are substantial, I do not believe Congress expected conservatorship to be a permanent state. Indeed, since the day the conservatorships were

[11] Section 401 of the Temporary Payroll Tax Cut Continuation Act of 2011, P.L. 112-78. The increase is not retained by the Enterprises but is passed through to the U.S. Department of the Treasury. This increase originally was scheduled to expire in 2021, but that year Congress extended the application of the increase until 2032.

announced, both Treasury and FHFA have sought the ultimate resolution of these failed companies to be determined by Congress. Congress wrote the charters, only Congress can change them.

As the conservatorships approach their 15th anniversary, it is asking a lot of an FHFA Director to continue to serve as both the regulator and conservator for these companies, continuing to make what would otherwise be private business decisions while regulating the companies. Setting prices for corporate credit guarantees of individual mortgages is a responsibility at the core of the secondary mortgage market activities, yet we are relying on administered rather than market-motivated processes to price this risk.

Furthermore, we need to understand that FHFA is no longer an independent agency as that term has been traditionally understood. Since the Supreme Court's Collins ruling in 2021, the Director serves at the pleasure of the President. That fact alone changes the *perception* of FHFA's actions, whether or not the Administration attempts to influence agency action on pricing, underwriting, or any other matter.

I conclude by encouraging this Committee and the Administration to focus on bringing these conservatorships to an end in a way that is both politically and economically stable and sustainable.

On behalf of HPC and its members, thank you for inviting me to participate today.

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Attachment 1:
HPC's April 27, 2023 letter to FHFA Director Thompson concerning the DTI pricing element of the January 19, 2023 FHFA announcement on g-fees.

April 27, 2023

HPC | HOUSING POLICY COUNCIL

Federal Housing Finance Agency
Office of the Director
400 7th Street, SW, 9th Floor
Washington, DC 20219

Re: Addition of DTI Element to GSE Single-Family Pricing Framework

Dear Director Thompson:

The Housing Policy Council (HPC)[1] and our member companies appreciate that the Federal Housing Finance Agency (FHFA) signaled to the industry that an update to the GSE pricing matrices was forthcoming in 2023, as highlighted in the 2022 and 2023 Enterprise Scorecards. This type of transparency benefits all market participants and stakeholders, providing advance notice that enables a level of preparation, even in the absence of details. That said, the inclusion of the new debt-to-income (DTI) adjuster as a core component of the new pricing matrices was an unexpected addition that creates risk to the borrower and negatively affects the borrower experience. The GSEs can fulfill the capital requirements established in the Enterprise Regulatory Capital Framework (ERCF) using existing mechanisms, including the base g-fees, loan-level pricing, and underwriting controls built into the Automated Underwriting Systems (AUS). In other words, the FHFA objective to align the capital standards with the pricing does not require the introduction of the DTI feature. In this letter, we present information about the significant negative impact of the DTI element and recommend that FHFA consider an alternative approach, such as an alteration to the loan-level pricing or base g-fees, both more effective and workable solutions to achieve the agency's objectives.

To be clear, HPC supports FHFA's desire to strengthen the GSEs' capital position, to support mission lending, and to promote the financial stability of the housing system. However, we are disappointed that the industry was not engaged in discussions as part of this significant operational and structural change. For example, FHFA had the opportunity to solicit feedback as part of the latest Capital Framework request for input (RFI) released in February, which covers the cross-guarantee (or "Super") fee. Among our concerns is that the new DTI pricing feature will require new processes and practices that will exacerbate the already elevated cost of mortgage origination, which will be passed on to the customer. Further, while the broader loan-level pricing changes can be operationalized within the given timeframe, the DTI-specific loan-level pricing change has multiple and lasting negative impacts for customers and the industry. Therefore, we request that FHFA further pause the August implementation for the DTI pricing adjuster until industry feedback can be fully considered. Should FHFA choose to postpone the implementation, we welcome the opportunity to partner with FHFA to examine alternative solutions.

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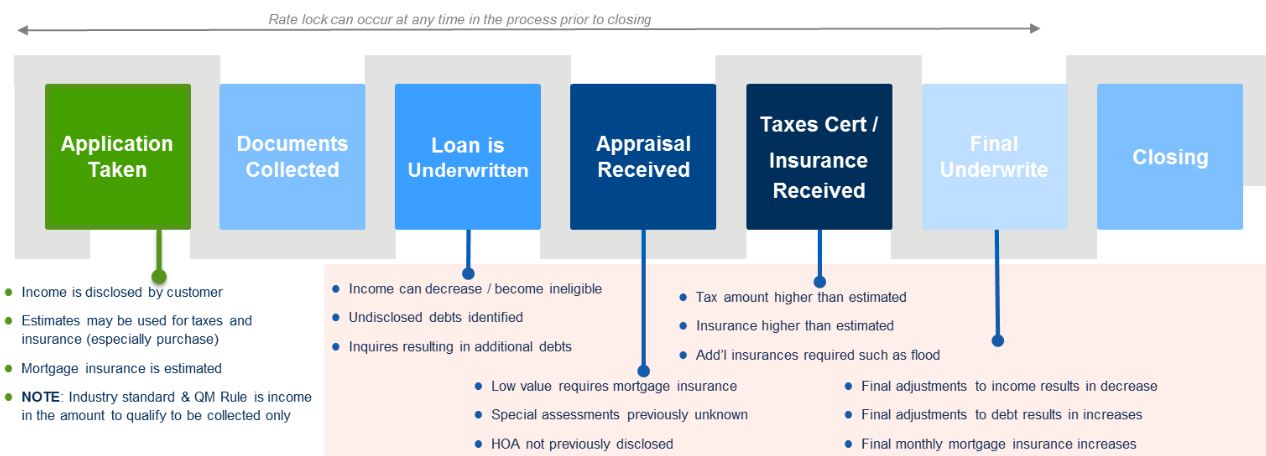
[1] The Housing Policy Council is a trade association comprised of the leading national mortgage lenders and servicers; mortgage, hazard, and title insurers; and technology and data companies. Our interest is in the safety and soundness of the housing finance system, the equitable and consistent regulatory treatment of all market participants, and the promotion of lending practices that create sustainable homeownership opportunities in support of vibrant communities and long-term wealth-building for families. For more information, visit www.housingpolicycouncil.org

Negative Impacts on Customers:

At the current level of mortgages approved by GSE automated underwriting that are not "mission rich" and have debt-to-income (DTI) ratios greater than 40 percent, a substantial percentage of customers will be negatively affected by the proposed pricing increase and by the uncertainty being introduced by the change. DTI ratios reflect a complex set of measurements and judgments. The lender assembles, verifies, and applies specialized treatment to various income types (e.g., when and how to handle commission or seasonal income) to demonstrate continuity and stability of borrower income. The underwriter must also assess the borrower's financial obligations for accuracy, relevance, and treatment, to include in the DTI calculation. This process occurs over a period of weeks; a precise DTI is rarely, if ever, discernable at the time of loan application. This is in stark contrast to the income eligibility check that is used to meet specific affordable lending program standards. Income eligibility determinations are not always obvious either but are far more simple than the DTI calculation.

The proposed DTI element has other serious, negative consequences:

1. *Paradigm Shift Away from Ability to Repay (ATR***):*** Today, once ATR has been established, additional income sources are not verified. This is true for manual and digital income verification paths, creating a simpler customer experience, reducing the collection of unnecessary income documentation, and moderating the underwriting judgment required – ultimately reducing the cost to originate.
2. *Reversal of Innovation and Efficiency Gains from Underwriting Digitalization***:** Multiple sources of digitally verified income are conservative by nature and have a tendency to underestimate the customer's income. The DTI change will lead lenders to replace digitally verified sources with manual alternatives, reversing the benefits of the GSE investments in automating income verification, that provides a lower cost and more efficient customer experience.
3. *Pricing Uncertainty Poses Transaction Risks and Undermines Consumer Confidence***:** DTI can change throughout the loan approval process and, as documentation is received and verified (such as income and debt outstanding), it could cause the customer's loan pricing to change, potentially multiple times (see below graphic for points in process that DTI may change).



Any of these items can cause the DTI to increase

4. *Each time customers' DTI changes to above or below the 40% threshold, lenders will be required to issue new disclosures, which may result in:*
   - Frustration over changing closing costs / interest rate

- Customer confusion about the multiple sets of disclosures
- Potential delay in closing timeframe
- Missed rate locks / lock uncertainty
- Contractual violations of Purchase and Sale Agreements

Re-Disclosure Requirement Overview

Changes in DTI >40% and <40%, creates a Change in Circumstance, as the change in DTI would trigger increase/reduction in pricing (potentially multiple times). Risks include:

- If a change in DTI occurs which triggers a loan-level pricing charge, lenders are required to re-baseline the Closing Disclosure (CD). As a result of the re-baseline, the consumer must then receive the closing disclosure no later than three business days before consummation, so a late change in DTI could impact the closing date for purchase customers.
- If lenders are not able to send a re-baselining Loan Estimate (LE) or Closing Disclosure timely, then they may have to "cure" the error without passing the cost on the consumer.
- If the change is on the CD and it causes the APR to change outside of tolerance, the consumer is entitled to an additional three-day waiting period.
- Penalties for violating the law are $4,000 in an individual action and $1M in class action, which add significant financial risk to lenders.

The pricing uncertainty introduced by DTI changes has the potential to not only undermine consumer confidence in the loan officer or lender directly, but may also lead to generalized frustration and inability to have reliable interest rate quotes upfront. This could undermine consumer confidence in the mortgage industry as a whole, and potentially generate complaints to regulators, including the CFPB.

5. *Change Results in Increased Origination Costs, Ultimately Passed on to Customers*: The proposed change will increase the overall cost to originate loans, with a disproportionate negative impact on smaller loan sizes. This is a result of the reduction in digital underwriting and need for repeated underwriting reviews, increased operational cost of managing change in circumstances requiring new system flags for income or debt changes that result in moving above or below the 40 percent DTI threshold and multiple re-disclosures, and increased repurchase risk due to the subjectivity of manual income calculations without the historically allowed 3 percent variance (see box below).

   The end result is that the cost of obtaining a mortgage will increase for all customers, and those customers with DTIs greater than 40 percent will be doubly impacted - once by the proposed change and again by the resulting increase in operational costs to implement the change.

Eliminating 3 Percent Variance: FHFA Setting New Precedent for Subjective Calculation

- Calculating DTI is known to be challenging and subject to judgment, which is why the GSEs established a 3 percent variance (subject to the DTI cap) without requiring loans to be repurchased. This allowance is not permitted for other loan-level pricing factors such as FICO, Purpose, Occupancy, Property Type, number of units, etc.
- The proposed DTI pricing element would assess a loan-level pricing adjustment on a component of a loan that requires judgment and where there is acknowledgement and recognition it will not be consistent, as not everyone has the same judgment.

***Unintended Impact on Equitable Housing Goals*:**

FHFA's recent revisions to the GSE pricing grids attempt to remove the perceived negative impact of risk-based pricing to mission lending by excluding certain lower AMI customers; however, the DTI change may actually have the unintended consequence of harming the efforts to close the homeownership equity gap for Black and Hispanic customers.

An analysis of 2022 HMDA data shows that the Racial Equity Gap persists across income bands: 72% of Black and 76% of Hispanic purchase customers are non-LMI, and 55% of Black and 61% of Hispanic purchase customers have income that exceeds 100% AMI.

HMDA Data Show that Opportunities to Reach Target Populations Increase With Income

A summary of analysis illustrates that the broader implications for minority customers may go even further and that opportunities to reach target populations increase with income:

- Income <$50,000, for every 100 white homeowners, there are ~51 Black homeowners, ~70 Asian homeowners and ~59 Hispanic homeowners
- Income $50,000 to $99,999, for every 100 white homeowners, there are ~68 Black homeowners, ~76 Asian homeowners and ~70 Hispanic homeowners
- Income $100,000 to $149,000, for every 100 white homeowners, there are ~81 Black homeowners, ~80 Asian homeowners and ~80 Hispanic homeowners
- Income $150,000+, for every 100 white homeowners, there are ~88 Black homeowners, ~90 Asian homeowners and ~88 Hispanic homeowners

Source and Full Analysis: Freddie Mac, Urban Institute and Census

Proposed Alternative Solution: Utilize Existing Tools to Minimize Customer Harm:

The GSEs could more effectively use their existing tools to raise additional capital, with options that include loan-level pricing, base g-fees, and AUS approvals to manage product mix, as they do today, including these options individually or in combination:

1) The approach that aligns most closely with current period capital needs of the GSEs would be to socialize or distribute the capital needs across the existing loan-level pricing grid (that is, earn the incremental capital by spreading the cost across all loan-level pricing cells).
2) Utilize a non-mission rich g-fee, which the GSEs have done previously. This increase would be the most customer-centric, as the increase would be negligible and would minimize the negative impact to customers already stretched by affordability. However, we recognize that this approach does not result in immediate capital build in the way that a loan level pricing does and it carries some modest duration risk for that model.
3) Adjust AUS models to further manage risk, loan mix, and non-mission lending.

In a study of agency volume for 4Q22 and 1Q23 quarters,[1] which was split into < > 40 DTI by FICO and LTV bands, an HPC member was able to size the amount of additional capital needed to meet the new DTI pricing requirement (approximately $225 million, based on 1Q23 deliveries). To earn the same amount of capital that would be raised by the proposed change utilizing the existing loan level pricing grid, it would have resulted in an average of 16 bps if socialized across the grid.

The equivalent increase needed in g-fee[2] for non-mission rich customers would be 3.3 bps assuming a duration of 5 years.

Note: The study is an approximation using publicly available data, and may not include all risk multipliers and features only available to the GSEs, but is believed to be substantially accurate

Pros & Cons of Loan-Level Pricing Adjustments **vs. GFee Changes to Meet Capital Requirements**

Consideration	Loan-Level Pricing **Approach**	**Guaranty Fee**
Replacement of Existing DTI Loan-Level Pricing *(Customer view)*	Larger negative impact, as it increases cash to close or rate, affecting affordability and smaller loan amounts	Nominal rate increase[2] with minimal impact as it's spread out over larger population and longer duration
Replacement of Existing DTI Loan-Level Pricing *(GSE view)*	More directly aligns with GSE current period capital build	Not as sufficient for replacement due to (1) time required to build capital and (2) duration risk associated with monthly fee vs. delivery fee
Ease of Implementation For GSEs and Lenders	Low - Simple loan-level pricing table update	Low - Multiple Gfee structures have existed previously
Risk Management Precision (beyond AUS)	Utilizing loan-level pricing grid allows for more precise and immediate revenue adjustments	Less precise management tool spread across non-mission loans, with longer period needed to increase capital

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Footnotes

1. **Study of GSE Volume for 4Q22 and 1Q23**
   Charts represent assumed loan-level pricing charges for each quarter if the capital charge is spread over ***all o****riginations in each FICO/LTV cell, regardless of DTI.*

1Q23 GSE volume - impact in bps to LLPA by cell based on 40% DTI mix

	LTV							
FICO	Sub 60	60.1-70	70.1-75	75.1-80	80.1-85	85.1-90	90.1-95	95+
780+	0	11	12	17	18	19	20	22
760-779	0	12	13	18	19	20	22	23
740-759	0	14	14	20	21	21	23	23
720-739	0	14	14	22	23	23	24	23
700-719	0	15	15	23	24	24	24	24
680-699	0	15	15	23	24	24	24	22
660-679	0	14	15	24	25	24	23	20
640-659	0	14	16	24	23	24	24	21
Sub 640	0	13	13	22	22	22	19	20

4Q22 GSE volume - impact in bps to LLPA by cell based on 40% DTI mix

FICO	LTV Sub 60	60.1-70	70.1-75	75.1-80	80.1-85	85.1-90	90.1-95	95+
780+	0	11	11	16	17	18	19	20
760-779	0	12	13	18	19	19	21	22
740-759	0	13	13	19	21	20	22	22
720-739	0	14	14	21	23	22	22	22
700-719	0	14	15	22	24	23	23	21
680-699	0	14	15	22	24	22	23	20
660-679	0	14	14	22	24	23	22	18
640-659	0	13	14	22	24	22	22	18
Sub 640	0	12	13	21	19	19	19	14

LLPA impact	201.28	$M	23Q1
LLPA impact	236.54	$M	22Q4

2. Potential G-Fee Increase to Cover Capital Requirements

		Duration options		
Vol $mm	Gfee calc	5yr	7yr	10yr
122,821	**23Q1**	0.033%	0.023%	0.016%
153,907	**22Q4**	0.031%	0.022%	0.015%

We recognize that the FHFA has indicated that the delayed implementation of the DTI loan level price adjustment is intended to provide the industry with sufficient time to develop new procedures that would be needed to apply this DTI adjustor. However, we do not believe that the DTI feature is workable, even with additional runway to establish alternative practices and controls. As we have described in this letter, the unintended negative consequences conflict with the FHFA's objective and, therefore, we encourage the FHFA to reconsider this approach. As we have also stated in this letter, existing alternatives are readily available: additional refinement to the loan-level pricing grids, increasing base g-fees, or adjusting automated underwriting rules could be used to achieve the FHFA objective. Thank you for your consideration of the points made here. If you or your staff have questions or would like to discuss the concepts that we have presented here, we would be pleased to discuss them with you.

Yours Truly,

Edward J. DeMarco

Edward DeMarco
President
Housing Policy Council

Attachment 2:

An excerpt from HPC's September 6th, 2018 written statement to the House Financial Services Committee for the hearing titled "A Failure to Act: How a Decade without GSE Reform Has Once Again Put Taxpayers at Risk." See page 15.

Preparing Borrowers to Become Sustainable Homeowners[12]

Before closing, it is important that I also address the other critical element of housing finance reform – how reform might advance the public policy interest in supporting home ownership opportunities for all Americans, especially for segments of our society that face heightened challenges in achieving home ownership. These are challenges HPC members address every day and they remain committed to seeking innovative and sustainable approaches to expanding home ownership opportunities.

A common element across many housing finance proposals is a goal to ensure homeownership is sustainable; that is, reducing the likelihood of default by borrowers, especially borrowers with less-than-perfect credit profiles. ***This requires more work and thought than simply subsidizing the cost of credit to low down payment, low credit score, or lower-income borrowers. It requires greater attention to saving both for down payments and for cash reserves once in the home, greater financial literacy, homebuyer education and home ownership counseling, and more effort to repair credit histories. Many HPC members sponsor and support programs that do these things.*** (emphasis added)

A challenge facing many lower income renter and owner households, indeed even moderate and some higher income households, is increased income volatility. Many people lack the resources to buffer themselves from life's disruptions, and income disruptions are more common today than in the past. Housing policy and our housing finance system need to become more attuned to this challenge so better solutions may be found.

Loan qualification standards also need to evolve and improve. Too often, Fannie Mae and Freddie Mac are looked to as the only means by which marginalized communities can be served, as the entities that bestow mortgage credit when private lenders will not. Instead, we should ask our secondary market to be open and available for securitizing eligible, privately credit enhanced mortgages while encouraging lenders in the primary market to innovate and to develop responsive and responsible products to serve the special needs of people and communities that face greater obstacles to home ownership.

[12] Testimony of Edward J. DeMarco, President, Housing Policy Council, before the House Financial Services Committee, September 6, 2018, page 15.