LEGISLATING G-FEES— *What's Next?*

BY ALLEN H. JONES

Last winter, Congress quietly raided the GSEs' cookie jar to pay for an extension of a payroll-tax holiday. It could prove the start of a much bigger development.

Although the statutory guidance provided by Congress was intended to fund a payroll tax extension, the legislation in question may move the industry closer to establishing a market-clearing price for the credit risk of mortgages. Law of unintended consequences, you say—sounds about right. Even with the administration's stated goal of reducing the role of government in housing, the explicit guarantee of mortgage credit risk by the federal government continues to reign supreme. However, as the political season unfolds, the runway lights for reducing the role of Fannie Mae and Freddie Mac are increasingly clear. Since the credit crisis began, housing policy has been tepid for fear of disrupting an economic recovery. Maintaining liquidity in the secondary mortgage markets and planning the withdrawal of government support has been a high-wire balancing act. Yet some maintain it has revealed the extent of the subsidy in guarantee fees (G-fees). With the Federal Housing Finance Agency (FHFA) preparing a mortgage credit risk offering for the market, the exercise of price discovery may provide the data needed by FHFA to set the market price for conforming mortgage credit risk—which we know will certainly increase from current levels. By default, this move will bring the private industry closer to market equilibrium and more competitive with a government-sponsored enterprise (GSE) execution. This article highlights the under-reported impact of legislation passed (H.R. 3765) that gives new authority to the FHFA to raise guarantee fees to accurately reflect the risk of loss and cost of capital—an amount that will likely exceed the 10-basis-point (10-bp) increase in guarantee fees we have seen so far this year.

House Resolution 3765

On Dec. 23, 2011, President Obama signed into law H.R. 3765, the Temporary Payroll Tax Cut Continuation Act of 2011. The bi-partisan legislation extended the payroll tax holiday for two months and delayed a scheduled cut of Medicare payments to doctors. With the bill's passage, an untimely and rancorous debate was avoided and the Congress engaged in its first statutory foray into the guarantee fee pricing of the secondary mortgage markets.

By passing H.R. 3765, the Congress prodded the regulator of Fannie Mae and Freddie Mac to take steps that accomplished expedient needs for the Treasury while tacitly challenging the ongoing crowd-out by the federal government in housing finance by raising guarantee fees.

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Specifically, H.R. 3765 required FHFA to increase the guarantee fees of the GSEs by at least 10 basis points for a period of 10 years, and the secretary of the Department of Housing and Urban Development (HUD) to do the same for its Federal Housing Administration's (FHA's) mortgage insurance premiums.

Guarantee Fees 101

On its website (www.fanniemae.com), Fannie Mae defines a guarantee fee as: ". . .one of the costs reflected in the interest rate on a single-family mortgage loan. This fee represents the charge by GSEs to guarantee that an investor in that loan will receive all scheduled principal and interest payments until the loan is repaid. The guarantee fee is compensation for assuming all credit losses and costs associated with loans that become delinquent and ultimately go to foreclosure."

We arrived at a 10-basis-point increase through an analysis of the lost revenue from the payroll tax cut prepared by the Congressional Budget Office (CBO). The CBO estimated that a 10-basis-point guarantee fee increase by the GSEs would raise $35.7 billion over 10 years and pay for the costs of H.R. 3765, while the proceeds from the FHA premium increase would be returned to the Mutual Mortgage Insurance (MMI) Fund.

Early analysis, however, of the 10-basis-point guarantee fee increase found it might be inadequate to cover the costs of H.R. 3765, according to industry trade media.

Fannie Mae on its website further distinguishes the guarantee fee increase resulting from H.R. 3765 as follows: "As mandated by Congress, the additional 10 bps fee will be remitted to the U.S. Treasury to help offset the cost of a two-month extension of the payroll tax cut. This is different than the historical role of the guarantee fee, which is to compensate Fannie Mae for the cost of providing a guarantee on mortgage loans. Fannie Mae provided information to lenders on this fee increase in a recent Selling Guide Announcement. Based on discussions with some lenders, the interest rate charged to borrowers may already reflect this mandated increase."

Fannie's website goes on to state: "Borrowers with 30-year, fixed-rate mortgages near the current conforming loan limit of $417,000 can expect to pay more than $8,500 over the life of the loan to fund the 10-basis-point fee. The FHFA, in consultation with the GSEs, will determine if future guarantee fee adjustments will be necessary to satisfy the requirements of the law. It is important to note that the current fee increase will affect only new loan originations. In most cases, the GSEs will charge lenders the higher fee only for loans that are securitized or sold to the GSEs on or after April 1, 2012."

In addition, H.R. 3765 directs the FHFA to discontinue volume discounts for GSE sellers by establishing uniform pricing, and prohibits the GSEs from reducing underwriting standards that may increase the risk of loss that are meant to offset the increase in guarantee fees. This change has a significant impact on the mortgage market, as it may lead to a "leveling of the playing field" between small mortgage originators and the large aggregators that received more competitive underwriting terms and guarantee-fee pricing in the past.

In sum, the various factions in the Congress compromised on a highly visible issue during the winter holiday season and used the GSE coffers to foot the bill. The ramifications of this congressional action as they relate to housing policy are far reaching and were addressed by the FHFA when it published an updated strategic plan for the GSEs 60 days later.

The precedent vis-à-vis guarantee fees

Mortgage industry trade press initially provided scant coverage of H.R. 3765. Then analysis from the fixed-income desk of New York–based UBS Securities LLC was published on Jan. 3, 2012.

The UBS Investment Research team published a widely reported UBS Mortgage Strategy update, titled *10 bp G-Fee Hike Not Enough,* in which it estimated that an increase of 10 basis points to the guarantee fees of the GSEs would not hit the CBO target of $35.7 billion.

Rather, UBS noted that the guarantee fees would have to be increased to at least 17 basis points to reach the cost target. The authors of the analysis also opined on the statute itself, noting: "[T]he law does state that the amount of the G-fee increase should 'appropriately reflect the risk of loss, as well as the cost of capital allocated to similar assets held by other private regulated institutions.'" In other words, the guarantee fee invoiced by the GSEs should be similar to the cost of capital for the banks.

This nuanced point of "appropriately reflecting the risk of loss and the cost of capital" is worthy of note because it served as the initial proscriptive statutory step toward price discovery related to conforming product, or establishing economic equilibrium for the GSEs where credit risk pricing responsibility is transferred from the GSEs to FHFA. And, given the precedent it set on using guarantee fees to pay for Treasury shortfalls, it also garnered the attention of our industry.

A subsequent attempt to use GSE guarantee fees to pay for other unrelated purposes came in March 2012, when the Nelson-Shelby-Landrieu RESTORE Act amendment to

S. 1813, the Surface Transportation bill, was added to pay for post-BP oil disaster Gulf Coast clean-up with guarantee fees. However, the measure was withdrawn when the Mortgage Bankers Association (MBA), Washington, D.C.; the National Association of Realtors® (NAR), Chicago; and the National Association of Home Builders (NAHB), Washington, D.C., objected.

In letters to Senate Majority Leader Harry Reid (D-Nevada) and Senate Minority Leader Mitch McConnell (R-Kentucky), MBA, NAR and NAHB collectively stated: "G-fees are a critical risk-management tool used by Fannie Mae and Freddie Mac to protect against losses from faulty loans. Increasing G-fees for other purposes—even just extending the current fee increase by one year at a lower rate—effectively taxes potential homebuyers and consumers looking to refinance their mortgages."

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Nevertheless, H.R. 3765 stands as law. And the legislated strategy of raising GSE guarantee fees or FHA mortgage insurance premiums over time may come to be remembered as the marker that began the movement toward credit risk equilibrium where private capital started to reduce the government's exposure to mortgage credit risk.

Some market pundits believe we have reached that market clearing point for FHA, at least from a volume perspective.

According to a posting dated March 30, 2012, titled *The Facts on FHA,* written by Acting FHA Commissioner Carol Galante and posted on The HUDdle, HUD's official blog (http://blog.hud.gov), FHA's insurance volumes are now decreasing and have dropped 34 percent since their peak in 2009.

FHA's market share is now declining for the first time since 2006. In fact, FHA endorsement volumes are returning to historical norms. In fiscal year (FY) 2011, FHA endorsement volume was lower than it was in FY 2003.

No challenge yet to GSE secondary market issuance

While we are beginning to see activity to suggest the private market is starting to test the water, it is still difficult to issue a private-label deal even when the underlying credit attributes of the mortgages are extremely strong.

For example, numerous media outlets (Reuters, Bloomberg, etc.) reported on New York–based Credit Suisse's recent efforts to bring a private-label residential mortgage-backed securitization (RMBS) to market. Those same media outlets reported that the deal was initially delayed as a result of concerns expressed by one agency—Fitch Ratings, New York. Two other agencies rated the deal as AAA.

According to a Business Wire announcement placed by Fitch Ratings' media relations team on March 30, 2012, "Fitch Ratings believes that the credit-enhancement amounts indicated for the CSFB Mortgage Securities 2012-CIM1 (CSMC 2012-CIM1) prime RMBS transaction [are] insufficient to reach the proposed ratings, particularly AAA."

The Fitch announcement went on to explain its position on the rating it assigned in detail, offering the transparency that the American Securitization Forum (ASF), New York, has advocated for in its current iteration of RMBS Project RESTART. Unfortunately, GSE mortgage-backed securities (MBS) issuance remains largely opaque, though FHFA is taking further steps to create transparency.

My company, RiskSpan, was one of the initial public voices in the market seeking greater transparency on loan-level detail from the GSEs. Published more than a year ago, we called for the release of proprietary loan-level loss data from the GSEs in a RiskSpan white paper so that private capital could gain equal footing on the loss data to build the next generation of predictive models to value RMBS. H.R. 3765 has forced the issue now, and FHFA has produced parameters and suggestions for the next phase of conservatorship.

FHFA publishes strategic plan for GSEs

Following up on the February 2011 Treasury/HUD white paper titled *Reforming America's Housing Finance Market,* in which options were explored conceptually, H.R. 3765 gave teeth to FHFA to establish guarantee fees for the GSEs that are reflective of a market-based cost of credit. This change may eliminate an implicit subsidy provided by the government to support the housing market and could lead to a reduced role of government in the housing market.

With the authority of H.R. 3765, on Feb. 21, 2012, FHFA delivered to the Congress a white paper titled *A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending.*

In that white paper, FHFA wrote the following guidance for contracting the GSEs' role: "Since entering conservatorship in September 2008, Fannie Mae and Freddie Mac have bought or guaranteed roughly three of every four mortgages originated in the country. Mortgages guaranteed by FHA make up most of the rest. Reducing the enterprises' position in the marketplace and doing so in a safe and sound manner, in the absence of other comparable private-sector players operating in this market, is the second strategic goal."

With the statutory provisions of H.R. 3765 and the following strategic plan for conservatorship, FHFA appears poised to bring to market a transaction where single-family mortgage credit risk is sold to private investors. Based on this type of transaction, FHFA will have the data needed to support changes to the guarantee fee that reflect a market-based price. It will also provide private capital with much-needed information to establish a market-clearing price for conforming mortgage credit risk.

While one could infer from H.R. 3765 that a sale of single-family mortgage credit risk to private investors is in the offing, it was confirmed and reported on at ASF 2012, the annual conference of the American Securitization Forum held in January in Las Vegas. On the last day of the conference, Bloomberg reported: "Freddie Mac, the U.S. government-controlled mortgage company, plans to sell this year securities that would transfer some risk associated with its portfolio to private investors, the *Financial Times* reported, citing Gregory Reiter, the company's [Freddie Mac's] vice president of security strategy and outreach."

RiskSpan attended the ASF conference and listened to the presentation. We realized then that when FHFA does bring the single-family credit risk transaction to market, the transaction will be priced based on risk perceived by private investors and their cost of capital. The FHFA white paper opines as such: "Gradually shifting mortgage credit risk from Fannie Mae and Freddie Mac to private investors could be accomplished in several ways. . . . Continued gradual increases in the GSEs' guarantee fee pricing may move their pricing structure closer to the level one might expect to see if mortgage credit risk was borne solely by private capital."

For mortgage bankers originating conforming product, this is the right time to begin thinking through the implications of H.R. 3765.

Will H.R. 3765 be remembered as a turning point?

In the run-up to the housing crisis, the GSEs imploded and required the single largest bailout provided by the U.S. taxpayer—that point is not in dispute. As we approach the three-year mark for conservatorship of the GSEs, the 2012 books of business appear to be of the highest credit quality. Most industry participants now worry that credit has become so tight that homeownership has become an almost impossible dream.

At the New Jersey Bankers Association's Economic Forum in January, Federal Reserve Bank of New York President and Chief Executive Officer William C. Dudley said: "Today's tough underwriting standards and high risk-based premiums for conforming loan borrowers should also be reviewed. I do not want to see a return to the lax standards and underpricing of credit risk of the boom period. But the guarantee fees for new purchase mortgages should be based on the expected losses on these mortgages—not the realized losses on loans of earlier vintages."

The Dudley comments, accompanied by ongoing litigation and uncertainty over compliance costs, also cloud the origination practices of mortgage bankers. Thus, the quandary over guarantee fees, and when to use the levers FHFA has at its disposal, given the slowdown in GSE purchase volume. According to the GSE websites, first-quarter 2012 volume increased on the margins just 0.4 percent compared with fourth-quarter 2011. The large majority of GSE securitization in the same time period was refinance volume. Current sales figures also are obscured by the anomaly of cash purchases by investors.

With the political season now under way and the Republican primary battle behind us, additional pressure will be placed on FHFA through continued efforts to force principal reductions on underwater loan balances of GSE mortgages. Housing policy will be front and center in the political debate because of the uncertainty in home prices, the public policy debate and the headline nature of practices like robo-signing. For example, according to a statement from Irvine, California–based RealtyTrac Inc. Chief Executive Officer Brandon Moore on April 11, 2012, on first-quarter 2012 foreclosure filings: "The low foreclosure numbers in the first quarter are not an indication that the massive reservoir of distressed properties built up over the past few years has somehow miraculously evaporated. The dam may not burst in the next 30 to 45 days, but it will eventually burst."

Even as housing policy becomes politicized in the campaign season, FHFA has proven its conservatorship credentials by following the statutory guidance the Congress has bestowed. With the enactment of H.R. 3765, FHFA follows its legislative mandate to establish guarantee fees at a price that reflects the market's perception of risk and expected cost of capital. By completing the sale of conforming mortgage credit risk to private investors, FHFA will gain invaluable insight into the market's cost of credit. Notwithstanding the real concerns over tight credit, engaging in pricing discovery could lead some market participants to choose alternatives to the GSE securitization programs.

What it means for mortgage bankers

As we learn more about how FHFA will implement H.R. 3765—and in particular the steps FHFA takes to set the GSE guarantee fees to appropriately reflect the risk of loss, as well as the cost of capital allocated to similar assets held by other private regulated institutions—we may well see economic equilibrium in the pricing of credit risk. In theory, that is one of the levers necessary to attract private capital back to the mortgage-backed securitization markets.

For mortgage bankers originating conforming product, this is the right time to begin thinking through the implications of H.R. 3765 and how it may impact the sourcing of mortgage product.

Larry Pratt, CMB, president and chief executive officer of First Savings Mortgage Corporation, McLean, Virginia, says, "As a true mortgage banker facing the stark reality of increasing guarantee fees, we are taking the prudent steps of exploring all of our options to achieve the best execution so that our production leaders maintain market share in a challenging environment. As the government continues to explore winding down the GSE role in housing finance, we are concerned with the frontline impact on the consumer. It's our role to fill the gap by identifying new sourcing options and providing our loan officers with innovative financing alternatives. The transition will take time, but it has our full attention."

Whole-loan sale opportunities to new entrants—competing as GSE guarantee fees increase—may emerge as an alternate channel. Ultimately, the successful mortgage banker in the evolving mortgage arena should prioritize the secondary market role as broader in scope to include exploring new sources of private capital. **MB**

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