



A Modest Recalibration of GSE Pricing

An Analysis

Jim Parrott

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On December 9, 2013, Federal Housing Finance Agency Director Ed DeMarco announced increases in the fees that Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs) charge for guaranteeing the credit risk on their mortgage-backed securities. The move would not have been particularly noteworthy had it not come the day before Congressman Mel Watt was confirmed to succeed DeMarco as director. Watt wasted no time walking the changes back, announcing not long after he was confirmed that he would suspend the changes until he had time to review them.¹

Watt and the Federal Housing Finance Agency (FHFA) used the opportunity to review the GSEs' pricing much more comprehensively; on April 17, 2015, they announced changes based on that review.² I describe their decision in detail below, but the upshot is that these changes represent a *very* modest recalibration of GSE pricing. Coupled with the FHFA's second announcement that day—tougher eligibility requirements for mortgage insurance companies that do business with the GSEs³—the agency has managed to better price the risk that the GSEs are taking on and pave the way for a more stable mortgage insurance industry, all without significantly affecting either the GSEs' bottom line or the cost to the consumer.

The Challenge: Replacing an Outdated Risk Premium

As the FHFA and the GSEs waded into this complicated thicket of issues, they came relatively quickly to two conclusions that would largely determine their course on pricing.

First, they decided that it was time to remove the “adverse market charge.” Back in 2008, the FHFA became concerned that its modeling to determine pricing did not adequately capture the increasing level of risk during the crisis. So the agency put in place an across-the-board, up-front fee of 25 basis points to capture the incremental risk. With the period of heightened risk behind us and the GSEs’ modeling much improved, the FHFA decided that it was no longer appropriate to rely on the overly blunt risk premium.

Second, the FHFA concluded that the total level of guarantee fees charged by the GSEs as of April 2015 was appropriate. Given the market feedback on Fannie and Freddie’s risk transfers and additional internal analysis, the agency determined that the GSEs are not underpricing the private market and that they are striking the right balance between an appropriate return for the taxpayer and maintaining broad access to credit.

With these two decisions, the challenge for the FHFA was to figure out how to replace the revenue lost by the removal of adverse market charge with loan-level price adjustments (LLPAs) that better capture the variable risk in lending, without unduly impacting access to credit.

Their Solution

To make the needed adjustments, the FHFA has divided the loans backed by the GSEs into three categories: loans for which pricing will go up, loans for which pricing will stay constant, and loans for which pricing will fall. Together, these changes—all of which are relatively small—are designed to offset the revenue lost from the adverse market charge and better price the relevant risk, without impeding access to mortgage credit.

For the first category of loans, the FHFA will replace the adverse market charge with an increase in LLPAs of 10–15 basis points a year, resulting in a slight net increase in annual pricing of 5 to 10 basis points, or 0.05–0.1 percent of the borrower’s loan amount. Two sets of loans fall into this category. The first is loans with “risk-layering,” or attributes that make them riskier than is indicated by their traditional credit characteristics. These include cash-out refinances, investor loans, and loans with secondary financing (piggybacks). The second is low-risk, high-balance mortgages: mortgages larger than \$417,000 with loan-to-value (LTV) ratios under 80 and borrower credit scores above 700.

For the second category of loans, the FHFA will replace the adverse market charge with an increase in LLPAs of roughly identical size, leaving pricing untouched. Another two sets of loans fit into this category. The first is low-credit risk loans within the traditional conforming size limits: less than \$417,000 with LTVs under 80 and borrower credit scores above 700. The second is higher-risk, higher-balance mortgages: greater than \$417,000 with LTVs over 80 or borrower credit scores below 700.

For the third category of loans, the FHFA will not replace the adverse market charge at all, giving borrowers a price decrease of 5 basis points a year. The loans in this group are higher-credit risk loans within traditional conforming size limits: less than \$417,000 with LTVs over 80 or borrower credit scores below 700.

The increase in pricing for the first category of loans will essentially pay for the decrease for the third category of loans, making the changes a wash to the GSEs.

The logic is relatively obvious for some of these changes. The FHFA believed that the GSEs' premiums were not sufficient to cover the increased risk in loans with risk-layering, so it made sense to capture some of the revenue lost with the adverse market fee by raising pricing on these loans. It also made sense to charge borrowers who can afford to take out larger loan balances slightly more, as they are unlikely to be priced out of the market as a result.

The logic behind other changes is less obvious, however. Among those with higher loan balances, for instance, the FHFA is increasing pricing for low-LTV borrowers but not high-LTV borrowers. Similarly, for those taking out more modest loans, the FHFA is holding pricing steady for those with low LTVs and *decreasing* it for those with high LTVs. In other words, the high-LTV borrowers are benefiting more from the changes than the low-LTV borrowers, despite the former posing higher risk.

The reason is at least in part provided by the FHFA's second major move of the day: the release of its new eligibility requirements for mortgage insurers (MIs).⁴ The new requirements should improve the MIs' financial health and thus reduce the risk posed to the GSEs in guaranteeing MI-insured loans, which are high-LTV. Thus, the FHFA decided to reduce pricing for high-LTV loans of modest size and hold them steady for higher-balance loans—because with these changes to the MI rules, the risk on those loans will drop relative to their lower-LTV counterparts.

That decision does not mean that higher-LTV borrowers are necessarily going to see their total pricing go down, however. MIs may increase their fees on higher-risk borrowers to account for the higher capital standards included in these requirements. If they do, then, taken together, the FHFA's moves on pricing and the MIs will have almost no effect on the total cost of credit for most consumers. Those with mortgage insurance will see the reduction in their GSE pricing offset by an increase in their mortgage insurance pricing, and most of those without mortgage insurance will see no change in their GSE pricing.

Those who do see some movement in their pricing are unlikely to notice, as the changes we are talking about are extremely modest. Ranging in size from 5 to 10 basis points in annual pricing, or 0.05–0.1 percent in the interest rate a consumer pays, these changes are a fraction of what one typically sees in the movement in rates in any given week.

Conclusion

The insignificant size of these moves is itself significant. The FHFA has managed to both recalibrate the GSEs' pricing so it more accurately captures their risk and take steps that greatly improve a central component of the housing finance system, all without impacting either the bottom line for the GSEs or the cost of credit for the consumer—an impressive feat.

Notes

1. For more background on guarantee fees, see Laurie Goodman, Ellen Seidman, Jim Parrott, and Jun Zhu, “[Guarantee Fees—An Art Not a Science](#)” (Washington, DC: Urban Institute, 2014).
2. “[FHFA Completes Guarantee Fee Review: G-fees to Remain at Current Levels with Modest Adjustments](#),” news release, April 17, 2015.
3. “[Fannie Mae and Freddie Mac Issue Revised Private Mortgage Insurer Eligibility Requirements](#),” news release, April 17, 2015.
4. For more background on mortgage insurer issues see Mark M. Zandi, Jim Parrott, and Cristian deRitis, “[Putting Mortgage Insurers on Solid Ground](#)” (West Chester, PA: Moody’s Analytics, Economic & Consumer Credit Analytics).

About the Author



Jim Parrott is a senior fellow at the Urban Institute and owner of Falling Creek Advisors, which provides financial institutions with strategic advice on housing finance issues. He spent several years in the White House as a senior advisor at the National Economic Council, where he led the team of advisors charged with counseling President Obama and the cabinet on housing issues. He was on point for developing the Obama administration’s major housing policy positions; articulating and defending those positions with Congress, the press, and the public; and counseling White House leadership on related communications and legislative strategy. Parrott was previously a senior advisor to Secretary Shaun Donovan at the Department of Housing and Urban Development. He has a BA from the University of North Carolina, an MA from the University of Washington, and a JD from Columbia University School of Law.



2100 M Street NW
Washington, DC 20037

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