Smaller G-Fees for Riskier Loans and Bigger Lenders

By: Jann Swanson | Fri, Jul 26 2013, 2:10 PM

Last week the Office of Inspector General (OIG) of the Federal Housing Finance Agency (FHFA) issued a report on FHFA's initiative to use guarantee fees charged by Fannie Mae and Freddie Mac to encourage the reentry of private money into the secondary mortgage market. **FHFA plans to gradually raise those fees**, commonly called G-fees, to allow more private competition with the government sponsored enterprises (GSEs), reduce their market dominance, and eventually wind them down. While it was tangential to the thrust of the OIG report, there was something of a history lesson on the **cross-subsidization of mortgage-backed securities** (MBS) utilized by the GSEs and FHFA's efforts to balance the system.

OIG defines a subsidy as a grant or other financial assistance typically given by the government to support a business entity. In the case of mortgage financing, the perceived implicit government guarantee and the ability of the GSEs to issue debt at a lower rate than private sector have provided a **significant pricing advantage** to the mortgage-backed securities (MBS) issued by the GSEs. Consequently the GSEs have transmitted at least a portion of their funding advantage to investors in the form of reduced G-fees.

In addition to the reduced fees enabled by federal support the GSEs have engaged in cross-subsidization, i.e. the practice of charging higher prices to one group of consumers in order to lower the prices for another group, across risk profiles. In the case of the GSEs this occurs when certain higher risk loan pools are subject to **lower guarantee fees** than they would otherwise pay based on the pool's credit risk profile because of the higher fees charged on lower risk pools. Historically, OIG says the GSEs utilized several types of cross-subsidization.

- When doing business with **large lenders** the GSEs usually employ swap programs. In a swap the GSEs obtain whole mortgage loans, securitize them and swap the resulting MBS back to the original lenders. Lenders who participate in swaps pay guarantee fees directly to the GSEs on the MBS they obtain. Alternatively, particularly when dealing with smaller lenders, the GSEs pay cash for the mortgages, securitize them and sell the MBS to investors. The selling lenders effectively pay the guarantee fees. MBS collateralized by mortgage pools sold on a cash basis to the GSEs by smaller lenders were subsidizing those collateralized by pools sold on a swap basis by larger lenders. Prior to 2008, when the GSEs were placed in federal conservatorship, they tended to negotiate **volume-based guarantee fee discounts to large lenders**.
- MBS collateralized by **lower risk** mortgages were **cross-subsidizing higher risk** mortgages. Lower risk mortgage pools were likely to contain mortgages with 15-year fixed-rate rates, higher credit scores, and/or low LTV ratios. Higher risk mortgages were likely to be comprised of loans with 30-year fixed rates or adjustable rates, low credit scores, and/or high LTV rates yet the GSEs did not charge G-fees that reflected the higher risk.
- Mortgages originated in **non-judicial foreclosure states** were subsiding mortgages originated in judicial foreclosure states where foreclosure processes tend to be more expensive and protracted. Traditionally the GSEs have not distinguished between the various geographic locations of mortgage pools nor considered state foreclosure laws in their pricing decisions.

In August 2012 FHFA required the GSEs to **take steps to reduce cross-subsidization** based on lenders sizes and product risk. The aggregate weighted-average G-fee increase at that time was expected to be **10 basis points** but the actual increase for each MBS pool is expected to vary by product and execution mechanism. FHFA also ordered the GSEs to aim for uniform pricing across all lenders regardless of their loan volume by applying differential increases for swaps and cash purchases. For example, increases would be larger for lenders delivering larger volumes of mortgages than those delivering smaller volumes and larger for adjustable rate mortgages and those with maturities longer than 15 years than for 15-year fixed-rate mortgages.

FHFA also announced it was soliciting public comment on increasing fees in states where foreclosure-related costs are statistically higher than average. This solicitation generated 60 letters from members of Congress, state attorneys general and major trade organizations. Many sought **transparency** regarding FHFA's calculations of foreclosure related costs and others questioned the impact on low-income borrowers and on the housing recovery in the five states affected by the higher costs. FHFA will make a decision about this change later this year.

OIG says that FHFA's G-fee cross-subsidization initiatives are likely to have **important ramifications** for the GSEs' financial soundness. It quotes GSE officials as saying their internal analysis indicates that recent fee increases are nearing sufficient levels to **encourage private sector financing** of lower risk mortgage products but that fees would have to rise considerably higher to attract that interest in higher risk products.

Thus there is, OIG says, a significant risk that the gradual increase in fees will introduce **adverse selection**. The private sector could conceivably capture a significant share of the GSEs' lower risk mortgage business leaving them with an increasing share of higher risk loans and the potential of incurring significant credit losses. FHFA disputes this saying that the cross-subsidization initiative mitigates the adverse selection risk by ensuring that guarantee fees appropriately reflect the risks of all types of GSE mortgage assets and that profits from concentrating increases on higher risk loans should prove attractive enough to encourages the private market to compete with the GSEs for these assets. This, OIG says, remains to be seen.

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