**Deborah H. Jones, CMB**

**Consumer Lending**

VAM265

10561 Telegraph Road

Glen Allen, VA 23059

deborah.jones@citizensbank.com

SVP, Director of Mortgage Capital Markets

Citizens Bank

August 28, 2023

The Honorable Sandra Thompson,

Director Federal Housing Finance Agency

400 7th Street, SW

Washington, DC 20219

Attention: Comment Intake

**RE:** **Enterprise Single-Family Pricing Framework Request for Input**

Dear Director Thompson:

Citizens[[1]](#footnote-1) appreciates the opportunity to provide feedback on the Federal Housing Finance Agency’s (FHFA) Request for Input (RFI) on the Enterprises’ Single-Family Pricing Framework. Given the criticality of the Enterprises role in the broader U.S. mortgage market in providing liquidity and access to homeownership, pricing is a key driver of a lender’s decision to deliver loans to the Enterprises or pursue an alternative execution.

We have worked closely with Housing Policy Council (HPC) and the Mortgage Bankers Association (MBA) and have aligned with their respective input, much of which is reflected in our commentary as well as our unique comments not included in either of the trades’ responses.

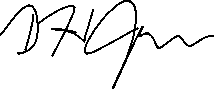
Overall, Citizens supports the Enterprise Regulatory Capital Framework (ERCF), recognizing that small adjustments may be necessary. We recommend that FHFA retain the ERCF and require pricing levels that will allow the Enterprises to earn FHFA’s targeted rate of return given the ERCF standards over a reasonable period of time. Citizens aligns with HPC’s suggestion that FHFA considers publishing the rate of return target that the agency sets and uses to assess the level of revenue generated by the Enterprises (as presented in the annual g-fee reports[[2]](#footnote-2)). We advocate for additional transparency as it would provide stakeholders a more meaningful perspective on risk and performance across the Enterprise books of business.

Further, as cited by the MBA, it is important to highlight areas where the ERCF remains too complex and instances where the ERCF has caused unintended consequences when directly used to set pricing, such as past policy decisions including the proposed DTI-based LLPA, since resolved, and the ongoing issue related to third-party-originated (TPO) loans. Each of these pricing moves arises from the ERCF, and each created problems that needed (or still need) to be addressed. Not all risk differentials in the ERCF need to be discreetly embedded in the pricing construct.

Lastly, we agree with HPC that an element of the pricing discussion is absent from this RFI as it relates to the Enterprises’ charter privileges which are those financial benefits and operating advantages that Fannie Mae and Freddie Mac derive from their government sponsored status. Any deliberation on pricing must acknowledge that, as a result of their federal charters, the Enterprises are advantaged by a lower cost of debt financing and a lower cost of capital. These financial benefits should not be ignored when considering Enterprise pricing levels and subsidies. The concept of a subsidy for borrowers stems, in large part, from these charter privileges whereby the Enterprises, by virtue of their status, are in a position to pass on lower costs to consumers. The recent conversation regarding cross-subsidization obscured the reality that the Enterprises’ ability to access credit at near-Treasury bond rates provides their unique pricing power. The Enterprises are competing against a private sector that does not have this bundle of benefits derived from the GSE charters. These benefits allow the Enterprises to achieve their mission objectives with minimal loan-level cross-subsidization.

Citizens has provided comments in the attached appendix to the specific RFI questions. We appreciate the thoughtfulness of FHFA’s proposal, and we hope that our responses will assist you in developing a final framework. If you have any questions or would like to discuss our response, please contact Deb Jones at [Deborah.Jones@citizensbank.com](mailto:Deborah.Jones@citizensbank.com).

Yours truly,



Deborah H. Jones

**Appendix A**

**Return on Capital**

1. *What is an appropriate long-term commercially reasonable return on capital threshold for the Enterprises to achieve?*

The FHFA and Enterprises have not made public their target rate of return on capital nor actual performance against that target and we request that FHFA make this information available, perhaps in the annual guarantee fee report. As FHFA well knows, an appropriate long-term commercially reasonable return on capital will generate the revenue required to fully satisfy the ERCF. This means that Enterprise g-fee pricing must adequately cover the risk of loss, expected and unexpected, with earnings sufficient to hit the target rate of return on capital.

However, there is an additional consideration. When contemplating an appropriate target for the Enterprises’ return on capital, it is important to acknowledge that for years the Enterprises were required to pay Treasury a 10 percent dividend on draws taken under the Preferred Stock Purchase Agreements. More recently, the net worth sweep owed to Treasury has been replaced with a dollar-for-dollar increase in Treasury’s liquidation preference for each dollar of retained earnings. As such, our view is that any targeted rate of return may need to start with a floor of at least 10 percent.

In the longer term, Citizens recommends FHFA consider further revisions to the ERCF to improve effectiveness and transparency, pending the finalization of the proposed Basel III rule in the US. Such changes will have both macroeconomic and sector impacts that could stunt economic growth and fundamentally shift the business line focus of regional banks.

Lastly, FHFA could consider addressing with Congress, redirecting the 10bp guarantee-fee payroll tax toward the ERCF. The housing industry should not be leveraged for non-housing related funds for the government. Redirecting this fee toward the ECRF would help achieve additional capitalization without increasing costs to consumers. We strongly encourage this be revisited with our lawmakers.

1. *To what comparable industries and companies should these return on capital thresholds be calibrated?*

While not a precise match, the multi-faceted line of operations of the Enterprises is most akin to banks, particularly large commercial banks that specialize in mortgage and other consumer credit activities. While less perfect, large, publicly traded mortgage banks are also a useful point of reference. The services the Enterprises undertake cover a range of activities including whole loan aggregation, asset management, securities issuance, master servicing, property management and disposition, all of which require critical risk management and counterparty oversight.

1. *Should FHFA set only minimum return thresholds for the Enterprises, or a range of returns – including a maximum return target?*

The FHFA should set a minimum rate of return to explicitly obligate each Enterprise to target sufficient revenue to satisfy the ERCF. This minimum could be expressed as a range, understanding that in any specific period, earnings could exceed or fall short of the target based on market conditions. While their unique federal charters and federal backstop in conservatorship provide for a lack of market competition, Citizens does not believe it is necessary to articulate a maximum return target.

1. *For which loan characteristics and products should the Enterprises accept a lower return?*

We first must acknowledge the cross-subsidization model, with full flat-pricing, does not work. It creates market distortions, encourages inappropriate risk-taking, and misleads consumers by removing beneficial pricing signals.

Further, subsidized pricing in an economic environment where homes are in short supply simply increases sales prices, exacerbating the already-acute affordability problem. The Urban Institute has estimated that approximately 23% of those receiving a cross-subsidy under the current Enterprise housing goals system are not low or moderate-income households.[[3]](#footnote-3) Instead of continuing to fine-tune cross-subsidization, this same amount of funding could be targeted directly to supporting borrowers defined in the Enterprise affordable housing goals and Duty To Serve requirements through explicit subsidies that provide financial assistance to the borrower and reduce the risk of the transaction.

It is also important to note 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. Specifically, 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 Enterprises should have an overall rate of return that enables earning a “fair return” for shareholders while also supporting broad liquidity and affordable mortgage rates in the single-family and multifamily housing finance market. The Enterprises should also maintain flexibility to set different rates of return for different products. Much like today, the Enterprises could have a lower rate of return on certain purchases including those serving low- and moderate-income borrowers and certain underserved markets. Calibrating pricing to better support “core mission borrowers,” can be done in several ways, including, but not limited to, targeting certain housing types such as manufactured housing or condominiums, or compressing the pricing grids across loan-to-value ratio and credit score dimensions in a targeted fashion. Allowing for flexibility in pricing and rate of return will be essential to supporting mission-based lending.

1. *For which loan characteristics and products should the Enterprises target a higher return?*

Loans that are not central to Fannie Mae and Freddie Mac’s public mission and that are capable of obtaining private sector financing may be suitable for higher targeted returns. Such products may include: (1) second home mortgages, (2) investment property mortgages, (3) cash-out refinance loans, and (4) high-balance loans.

1. *How should return on capital be calculated for the Enterprises?*

The return on capital should be calculated to be sufficient to cover all the Enterprise’s business and operating costs and losses. In other words, the calculation must be set at a level that will generate the revenue required to fully satisfy the ERCF, which must cover the risk of loss, expected and unexpected, with earnings sufficient to hit the target rate of return on capital.

**Process**

1. *With what frequency should FHFA consider updating the upfront guarantee fee grids?*

FHFA should reconsider the upfront fees every one-to-three years, depending on changing economic conditions, any changes to ERCF, and the results in the annual G-Fee study. Pricing realignments should always reflect the level of risk to the Enterprises and the capital required to support that risk. Further, adequate notice should be provided to the industry to execute pricing changes, with substantial transition time during periods of high production volume or adverse market conditions.

Citizens appreciates that FHFA has attempted to give ample implementation time for policy changes to avoid market disruption such as impacts to lenders’ pipelines. Pricing changes require a multitude of process and technology changes that, for major changes, can take several months. For example, for the most recent pricing changes announced on January 19, 2023, which had a delivery-based effective date of May 1, 2023, we would have had only 2 weeks to prepare for and begin implementation to meet the start date. Based on our experience and feedback we have heard from other lenders, we feel these timelines need to be reevaluated and extended. This is particularly important for supporting mortgages on new construction.

Lastly, we would recommend that FHFA accept public comments on all proposed pricing changes. It is important to note that we are not recommending a formal notice and comment period, as that would make pricing changes too arduous. We understand that FHFA needs to remain nimble to adapt to changing market conditions and make pricing changes relatively quickly. Providing an avenue for industry to engage and provide comments on those changes, however, could help FHFA uncover potential operational or implementation issues that could arise from pricing changes – much like problems caused by the debt-to-income (DTI) based LLPA. One possible way to accomplish this would be for FHFA or the Enterprises to convene an Implementation Advisory Board, similar to what Fannie Mae did during the Great Recession. This was comprised of several lenders of varied sizes who weighed in on potential pricing (and other) changes before they were announced, again with hopes of avoiding any unworkable constructs or problematic implementation issues. Confidential polling questions and answers helped the Enterprises, lenders and vendors understand the collective readiness of the industry, while dialogue provided solutions to operational challenges.

**Components of Guarantee Fees**

1. *In achieving commercially reasonable returns over time, should future guarantee fee changes be executed through ongoing guarantee fees or upfront guarantee fees?*

The FHFA should continue to permit adequate flexibility for the Enterprises to effectively use all their existing tools to meet the capital standards, including loan-level pricing, base g-fees, credit standards to manage product mix, and loss mitigation to reduce the severity of losses.

1. *Should upfront guarantee fees be eliminated?*

No. The upfront fees are one of the most significant post-crisis reforms put in place to help safeguard the safety and soundness of Fannie Mae and Freddie Mac in addition to the broader economy.

1. *Should risk-based pricing be calibrated to the ERCF?*

In large part, yes. Capital standards are a traditional and proven safety and soundness tool for financial regulators. The ERCF is based on a comprehensive analysis of the risk characteristics of each Enterprise’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, Enterprise 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. Earning a commercially reasonable rate of return would enhance safety and soundness of the system, given the substantial role that the Enterprises play.

However, reconsideration should be given to some risked-based pricing elements. Of primary concern are variations in Enterprise pricing for loans with substantially similar credit characteristics based on origination channel – specifically pricing penalties with respect to TPO loans. At least one of the Enterprises is providing worse execution/pricing on TPO loans relative to retail loans solely due to this difference in origination channel, and the disparity in pricing stems from the higher risk multiplier for those loans in the ERCF. Coupling this with observed practices of one or both Enterprises, charging price penalties for not delivering a combination of a ‘representative mix’ of equal market share to each GSE, limited levels of TPO loans and unattainable affordable goal percentages, in these market conditions, even minor misses, makes for complexities and inefficiencies. This results in increased costs to the consumer, and bidding wars through the TPO channels that include competing with the Enterprises Cash Window (Fannie Mae, specifically). The TPO channels often help lenders achieve affordability targets. If an Enterprise is pricing for counterparty risk or prepayment speed concerns that should be achieved directly with each lender through other pricing components such as Coupon Price Adjusters (CPAs).

The reported disparities in pricing for TPO loans are a dramatic departure from the core and vital level playing field principle FHFA has established. Lenders of varying sizes, charters, or business models – including those that specialize in different origination channels – must have the ability to compete on a level playing field as long as they deliver investment quality loans. All pricing differences should be based on loan-level factors that influence risk. FHFA has not presented compelling evidence that an equivalent loan with identical characteristics is riskier based upon origination channel supporting the need for a higher risk multiplier for TPO loans. One could argue that the TPO channels are higher quality, given lenders’ common practices of pre-purchase reviews in addition to required pre-funding Quality Assurance and post-closing Quality Control and the ultimate representation and warranty burden on the acquiring lender.

Citizens understands that a robust and well-balanced capital framework is critical to ensuring the Enterprises can operate in a safe and sound manner, and that the ECRF, on some level, will influence pricing decisions. However, it is clear that the Enterprises’ pricing grids cannot always be a literal translation of the ECRF. We would recommend that the Enterprises be granted flexibility to use methods other than pricing to manage certain risks to avoid unintended consequences and disruptions to the mortgage market, such as changes in the credit model.

1. Citizens (Citizens Financial Group, CFG) is an OCC regulated bank, headquartered in Providence, Rhode Island, with $222b in assets. [↑](#footnote-ref-1)
2. https://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Guarantee-Fees-History.aspx [↑](#footnote-ref-2)
3. [Urban Institute: *Access and Affordability in the New Housing Finance System*](https://www.urban.org/sites/default/files/publication/96461/access_and_affordability_in_the_new_housing_finance_system.pdf) : Jim Parrott, Michael Stegman, Phillip Swagel, Mark Zandi (February 2018) [↑](#footnote-ref-3)