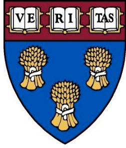

HARVARD LAW SCHOOL

CAMBRIDGE · MASSACHUSETTS · 02138

Adam J. Levitin
Bruce W. Nichols Visiting Professor of Law

November 20, 2012

FHFA OPAR
400 Seventh Street SW., Ninth Floor
Washington, DC 20024
gfeeinput@fhfa.gov

Re: No. 2012-N-1

To Whom It May Concern:

We are law professors at Harvard Law School, City University of New York Law School, and Albany Law School. The mortgage market is a major focus of our scholarship. We have each authored several articles about the US primary and secondary mortgage markets, and testified repeatedly before Congress on mortgage market reform and foreclosures.

We are writing to express my opposition to the FHFA's proposed state-level adjustment of g-fees based on standard deviation in cost/day to obtain marketable title post-default. The proposed methodology is statistically unsound in several ways, misguided as a matter of policy, inconsistent with the historical mission of the government sponsored enterprises ("GSEs") to create a national mortgage market, and *ultra vires* as it does not further the FHFA's conservatorship mission. These concerns with the proposed rulemaking are detailed in the letter below.

1. The FHFA's Proposed Method for Setting the G-Fee Is Statistically Unsound Because It Assumes Past Carrying Costs Are Predictive of Future Carrying Costs

The FHFA proposes setting the g-fee for *future* loans based on the default carrying costs of *past* loans. This method makes sense only if past carrying costs will be predictive of future carrying costs. The proposed rulemaking presents no evidence to support such a prediction and there is a good deal of evidence to suggest that in current market conditions the performance of existing loans will be a poor indicator of the performance of loans made in the future.

In particular, the proposed rulemaking ignores that carrying costs relate in part to the volume of mortgage defaults, which suggests that future carrying costs are likely to be lower than those from existing loans. There is a 66% correlation between the volume of mortgage defaults and the level of foreclosure inventory, which suggests that there is limited system

1545 Massachusetts Avenue • Areeda Hall 132
Cambridge, MA 02138
alevitin@law.harvard.edu • 617.384.5979

bandwidth for processing foreclosures.[1] Servicers, courts, and the market have limited capacity for handling defaults, adjudicating cases, and absorbing properties. Limited system bandwidth for processing foreclosures means that elevated default volumes extend foreclosure timelines and increases carrying costs and thus increase loss-given-default.

Pre-2008 mortgage underwriting standards have combined with post-2008 economic conditions to produce an unprecedented level of mortgage defaults, which have overwhelmed system bandwidth and increased carrying costs. Going forward, however, it is clear that mortgage default volumes will be significantly reduced, as underwriting standards have tightened significantly and economic conditions have stabilized. Therefore, as the market works through the defaults on the pre-2008 loan vintages, default levels should return something near their historical level, resulting in lower carrying costs for defaulted mortgages. This means that a g-fee calculation methodology based on estimated carrying costs derived from past carrying costs is inherently flawed, as past carrying costs are unlikely to be predictive of future carrying costs.

The notice of proposed rulemaking claims that the g-fee methodology is not retrospectively based, but the substance of the methodology belies that claim. The notice of proposed rulemaking states that:

> The methodology used by the agency to develop the planned approach addresses only differences in the expected cost of defaults associated with single-family mortgages that will be acquired by the Enterprises in the future and are underwritten according to current standards. If FHFA had developed an approach using information on the realized default losses on loans the Enterprises acquired in the past decade, which were originated under less stringent underwriting guidelines, the increases in upfront fees in the states affected would be significantly greater, because recently acquired mortgages are expected to default at lower rates due to strengthened underwriting standards.[2]

Despite the FHFA's protestations in the notice of proposed rulemaking that past data is not being used to set g-fees on future loans, this is clearly what is happening. The data presented in the notice of proposed rulemaking is taken directly from the *current* GSE servicer guides for managing existing loans, and not for loans to be made in the future. These timetables are periodically adjusted by the GSEs to reflect changing market and underwriting conditions, but they are reflecting the performance of existing, rather than future loans. Accordingly, it makes no sense to blithely use these timetables, which reflect current market conditions, for pricing future loan guarantees.

2. Standard Deviations in Loss-Given-Default Are Not a Statistically Sound Method for Setting G-Fees Because They Do Not Account for the Actual Size of Loss-Given Default

The FHFA is proposing setting the g-fee based on standard deviations from the mean

[1] Analysis of Mortgage Bankers Association National Delinquency Surveys.

[2] 77 Fed. Reg. 58992, Sept. 25, 2012. It is not clear, however, what this language means. It is possible to read it as clarifying that the proposed g-fee would be set based on carrying costs of defaulted loans, rather than total loss-given-default (which includes carrying costs), but it is also possible to read as clarifying that the proposed g-fees would be set based on future anticipated carrying costs, rather than on past carrying costs.

1545 Massachusetts Avenue • Areeda Hall 132
Cambridge, MA 02138
alevitin@law.harvard.edu • 617.384.5979

foreclosure timeline. This methodology is statistically unsound because it fails to account for the actual size of variations in loss-given-default on a mortgage. Standard deviation measures how extreme a data point varies from the mean of data points. It does not measure the absolute value of the variation. Therefore even a small absolute variation from the mean could be many standard deviations from the mean. The actual variation could be much less than the additional g-fee.

It is unclear what interest the GSEs have in the variation in carrying costs among the states; the GSEs' interest is instead in absolute carrying costs. The proposed rulemaking is not sensitive to absolute variations, and as such is not a sound methodology for risk-based pricing. The problem of reliance on standard deviation is particularly acute because of the likely difference in loss-given-default for existing and future loans. Absolute variation in loss-given-default for future loans is unlikely to be as large as for existing loans, yet the proposed methodology would not account for the difference.

3. Loss-Given-Default Is a Statistically Unsound Basis for Setting the G-Fee Because It Does Not Account for Probability of Default.

The FHFA's proposed g-fee methodology purports to be a cost-saving measure for the GSEs, and thus consistent with the FHFA's conservatorship role. Yet by focusing solely on losses-given-default and not on probability of default, the proposed g-fee could actually result in greater losses to the GSEs in the future. When guaranteeing a loan, the GSEs assume the credit risk on the loan. This risk is the product of the probability of default times the loss given default (carrying costs). If loss-given-default is high, but the probability of default is low, then a loan guarantee may pose less risk to the GSEs' than if loss-given-default were low and the probability of default were high. Structuring g-fees to discriminate based on loss-given-default, rather than on total risk (probability of default times loss-given-default) penalizes states with low default rates but high loss-given-default. These states may have higher losses-given-default precisely because of their low default rates. There may be an adverse selection in terms of the losses on the loans that actually do default.

One reason that some states have lower default rates is because of stronger consumer protection laws that discourage riskier-lending up-front. Texas, for example, has some of the most consumer-protective borrowing laws up-front and has had lower default rates than the national average during the last few years despite having a large number of borrowers with poor credit. The proposed g-fee would have the perverse effect of discouraging states from having strong post-default consumer protection laws without encouraging them to have stronger anti-predatory lending laws.[3] The result could well *increase* losses to the GSEs in the future.

4. Increases in Carrying Costs Since the Fall of 2010 Are Presumptively Due to Robosigning and Should Be Borne by Servicers Rather Than Homeowners

[3] Moreover, the proposed g-fee fails to weight foreclosure timelines by population or number of mortgages per state. Thus, if the most populous states have more protections, they are treated as outliers even if they represent a majority of mortgages. The proposed g-fee structure would treat thinly populated states like North Dakota and Rhode Island as equivalent to California.

1545 Massachusetts Avenue • Areeda Hall 132
Cambridge, MA 02138
alevitin@law.harvard.edu • 617.384.5979

There have long been significant state-by-state variations in the costs of carrying defaulted loans depending. Carrying costs have increased in virtually all states since 2008, but with notable increases occurring since the emergence of the "robosigning" scandal in the fall of 2010. Some states responded to the robosigning scandal by increasing the procedural protections for homeowners or by simply enforcing existing protections more vigorously. All of this has unquestionably added to the GSEs' carrying costs.

It is unfair and simply bad policy, however, to impose these added costs on future homeowners, when they were created because of the misbehavior of mortgage servicers in the past. Increasing g-fees in response forces future borrowers to pay to cover the compliance failures of the GSEs' servicers. The least cost avoider of these costs, however, are the servicers, not the homeowners. Servicers should be forced to internalize the costs they have created for the GSEs, and a reduction in carrying costs needs to start with proper GSE and FHFA oversight of mortgage servicers, rather than with attempts to coerce states into eliminating procedural protections for borrowers through an exercise of the GSEs' monopsony power.[4] Increases in carrying costs post-robosigning should be borne by servicers, not by future mortgagors.

5. FHFA's Refusal to Permit Principal Reductions Is Exacerbating Foreclosure Rates and Losses Given Default.

FHFA's own actions and inactions have also contributed to the volume of foreclosures and hence losses for the GSEs. FHFA's steadfast refusal to permit the GSEs to forgive principal on underwater loans has resulted in an increase in foreclosures. At best this is a pennywise, pound-foolish policy, but to then compound it with punitive g-fees for borrowers in states that insist on meaningful consumer protection is akin to a patricide complaining about probate delays. FHFA does not have clean hands in the foreclosure crisis.

Similarly, the FHFA's on-going toleration of the GSEs' use of the Mortgage Electronic Registration System (MERS) has increased losses-given-default because of the confusion and litigation that the use of MERS has caused in foreclosure cases. Even if MERS is a valid system for immobilizing mortgage title (itself not entirely clear), the confusion and delay created by MERS in foreclosure litigation easily offsets its benefits. Likewise, the FHFA's on-going toleration of the GSEs' policy of bringing foreclosures in the name of the servicer or MERS has added significantly to the costs of foreclosure litigation and hence losses-given-default. All of this is to say that if the FHFA is truly concerned as a conservator with reducing the GSEs' losses given default, there are many more logical places to start than trying to reduce variation, but not the absolute level of carrying costs of defaulted loans.

[4] Whether the proposed g-fee methodology is itself a violation of the antitrust laws is beyond the scope of my comments, but it is not clear that when the GSEs' act as conservator that they are automatically immune from antitrust liability.

1545 Massachusetts Avenue • Areeda Hall 132
Cambridge, MA 02138
alevitin@law.harvard.edu • 617.384.5979

6. The FHFA's Proposed State-Level Variation in G-Fees Is *Ultra Vires*

The FHFA's g-fee proposal is outside the scope of FHFA's authority as conservator of the GSEs.[5] Among the FHFA's powers as conservator is the authority to operate the GSEs. As part of this the FHFA may "perform all functions of the regulated entity in the name of the regulated entity which are consistent with the appointment as conservator or receiver" and to "preserve and conserve the assets and property of the regulated entity."[6] Moreover, the FHFA is authorized to "take such as action may be (i) necessary to put the regulated entity in a sound and solvent condition; and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity."[7]

The g-fee proposal is not consistent with performing the functions of the GSEs. The GSEs have never historically engaged in discriminatory pricing among the states, and such discriminatory pricing is affirmatively contrary to the GSEs' mission, namely

> promot[ing] 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.[8]

A major role the GSEs performed historically was to eliminate regional variation in the availability and cost of mortgage credit.[9] The proposed g-fee methodology would undermine this historical GSE mission.

Similarly, the g-fee proposal is affirmatively not part of the FHFA's duty "to preserve and conserve the assets and property of the regulated entity." This is because the g-fee proposal aims simply at reducing the variation in foreclosure timelines among states, rather than reducing foreclosure timelines themselves. Foreclosure timelines could actually *lengthen* under the GSEs' proposal, resulting in greater losses to the entities and ultimately the taxpayers.

The proposed rulemaking "recognizes that unusual costs associated with practices outside of the norm in the rest of the country should be borne by the citizens of that particular state rather than absorbed by borrowers in other states or by taxpayers."[10] Nothing, however, in the FHFA's conservatorship mission requires FHFA to eliminate any of the myriad cross-subsidies that exist in the mortgage market. The fact that borrowers in one state subsidize those in another state does not affect the GSEs' losses, and there is no allegation of this, much less supporting evidence presented in the notice of proposed rulemaking. The g-fee proposal has nothing to do with the FHFA's conservatorship authority to the GSEs "in a sound and solvent condition". It is not "appropriate to carry on the business" of the GSEs or even to "preserve and conserve" their assets and property. In short, FHFA's g-fee proposal is *ultra vires*. It is not authorized by

---

[5] We also note that there may be Constitutional issues with the FHFA singling out five states that are "outliers" for punitive treatment, particularly in terms of the possible violation of the privileges and immunities of these states' residents and the states' rights under the 10th Amendment.

[6] 12 U.S.C. § 4617(b)(2)(B).

[7] 12 U.S.C. § 4617(b)(2)(D).

[8] 12 U.S.C. § 1716(4).

[9] *See, e.g.*, Adam J. Levitin & Susan M. Wachter, *The Public Option in Housing Finance*, 46 U.C. DAVIS L. REV. (forthcoming 2013).

[10] 77 Fed. Reg. 58994, Sept. 25, 2012.

1545 Massachusetts Avenue • Areeda Hall 132
Cambridge, MA 02138
alevitin@law.harvard.edu • 617.384.5979

statute, even with a generously broad reading of conservatorship, and does not appear to be authorized by any of FHFA's non-conservatorship powers.

Instead, the proposed alteration in the g-fee methodology represents the FHFA's pursuit of a policy distinct from conservatorship and appears to be motivated by a political animus toward particular state consumer protection policies (an animus also borne out in FHFA's aggressive litigation campaign to preempt state consumer protection and housing code laws) rather than conservation of the GSEs' assets and protection of taxpayers from losses:

> If those states [with higher carrying costs] were to adjust their laws and requirements sufficiently to move their foreclosure timelines and costs more in line with the national average, the state-level, risk-based fees imposed under the planned approach would be lowered or eliminated.[11]

The proposed g-fee methodology appears to be a punitive measure aimed at browbeating states into abandoning consumer protections in the midst of the country's worst foreclosure crisis. This is not just questionable policy. It is also beyond the scope of FHFA's authority as conservator.

For all of these reasons we strongly urge the FHFA not to adopt the proposed revision to the structure of the g-fee.

Sincerely,

/s/Adam J. Levitin
Bruce W. Nichols Visiting Professor of Law
Harvard Law School
Cambridge, Massachusetts;
Professor of Law
Georgetown University Law Center
Washington, DC

/s/Alan White
Professor of Law
CUNY School of Law
New York, New York

/s/Elizabeth Renuart
Associate Professor of Law
Albany Law School
Albany, New York

[11] *Id.*

1545 Massachusetts Avenue • Areeda Hall 132
Cambridge, MA 02138
alevitin@law.harvard.edu • 617.384.5979