TREAT FANNIE AND FREDDIE AS UTILITIES

Eric Stein
Bob Ryan

March 2020
About the Authors

Eric Stein is Senior Vice President of Self-Help, a credit union and community development organization that creates ownership and economic opportunity for all. Self-Help has provided $8.5 billion in financing and has 150,000 members. Self-Help's policy affiliate, the Center for Responsible Lending, is a nonprofit, non-partisan organization that protects homeownership and family wealth by fighting predatory lending practices. Eric served as Special Advisor to Federal Housing Finance Agency (FHFA) Director Melvin L. Watt. FHFA is conservator of Fannie Mae and Freddie Mac. He also served as Deputy Assistant Secretary for Consumer Protection in the U.S. Department of the Treasury. He was responsible for developing, and then working with Congress to enact, legislation to create the Consumer Financial Protection Bureau and reform the mortgage market. Eric holds a law degree from Yale Law School and a BA from Williams College.

Bob Ryan is co-owner of Parrott Ryan Advisors, which provides financial institutions with strategic advice on housing finance and business issues. Bob left the Federal Housing Finance Agency (FHFA) in July 2019 after spending five plus years as Special Advisor to the Director. From July 2015 through September 2018 he was also the Acting Deputy Director for the Division of Conservatorship. Prior to Joining FHFA Bob served as Senior Vice President of Capital Markets at Wells Fargo Home Mortgage. He was responsible for strategic policy impacting capital markets and the mortgage company. From 2009 to 2012 he was Senior Advisor to HUD Secretary Donovan, the Acting Federal Housing Administration (FHA) Commissioner and Assistant Secretary for Housing, and prior to that the first Chief Risk Officer for FHA. In that capacity, Bob was responsible for establishing a new Office of Risk Management that oversees FHA's credit risk management functions, including single-family, multifamily and healthcare. Prior to HUD Bob was at Freddie Mac, where he held several senior positions in capital markets, single-family pricing and credit and the Office of the President. Bob has over 35 years of experience in all aspects of the mortgage market.

Acknowledgments

The authors would like to thank Nikitra Bailey, Mike Calhoun, Tom Feltner, Mark Lindblad, Ricardo Quinto, and Eric White of the Center for Responsible Lending and Martin Eakes of Self-Help, in addition to Richard Cooperstein, Ken Fears, Mark Goldhaber, Don Layton, and Jim Parrott, for help in the development of this paper.
Introduction

After 11 years of government conservatorship, the Trump administration and the Federal Housing Finance Agency (FHFA) have announced that they will permit Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs), to build capital and exit conservatorship. As FHFA Director Mark Calabria has indicated, “while I’m committed to working with Congress, I’m not going to wait on Congress.” Most observers believe congressional action on the GSEs is highly unlikely. As part of the exit, the government will continue its existing support provided through the Senior Preferred Stock Purchase Agreements (PSPAs), under which the Treasury Department agrees to cover any net worth shortfalls at the GSEs. FHFA and Treasury have implemented the first stage of moving the GSEs out of conservatorship by permitting the two GSEs combined to retain $45 billion in capital, a significant increase from the previous level of $6 billion.

At this point, FHFA and the administration have a critical choice to make. Does FHFA continue its current practice within conservatorship of treating the GSEs as return-regulated utilities, setting a reasonable and fair target band for returns on equity that is lower than the returns they would naturally pursue on their own? Or does FHFA treat them as more traditional private sector companies free to charge what the market will bear, providing higher returns than a utility target band? The answer to this question is important, as it will determine how the GSEs function upon their release—how they price their guarantee of mortgages, what kind of business risks they pursue, and how they compete with one another and others in the market.

Applying Utility Rate of Return Regulation to the GSEs

Utility regulation has been adopted in the United States when two conditions are met. First, the regulated entities provide services that are essential for the wellbeing of society. Second, the firms’ business naturally leads to market concentration and often monopolization. Because they operate in far less competitive markets, only government-regulated rate of return “to enforce the pricing discipline on monopolies that competitive markets impose on most firms” can ensure they do not take advantage of their positions to overcharge their customers.

The electric power industry offers a helpful example. As electricity is an essential service subject to extreme concentration, regulators have imposed utility regulation on investor-owned electric companies and other monopolies for the past 100 years. In fact, investor-owned utilities, which are “private companies, subject to state regulation and financed by a combination of shareholder equity and bondholder debt,” serve about three-quarters of the U.S. population today.

The two preconditions for utility regulation that apply to electric companies also apply to the GSEs. First, providing liquidity to the national housing finance market, as made manifest by the government takeover of Fannie Mae and Freddie Mac during the financial crisis, is an essential service. Second, their large economies
of scale, the statutory requirement to serve the entire nation, and government advantages including their implicit guarantee prior to the crisis and the net worth support provided through the PSPAs today, have resulted in substantial market concentration and a duopoly. Because of these two factors, the best model for their regulation outside of conservatorship is utility regulation.8

Impact of the Utility Return Regulation Decision on the Market

If FHFA and Treasury were to allow the GSEs to set their return on equity (ROE) unchecked by a utility-like process, the more aggressive return targets would undermine the way that they serve the housing finance system in three critical respects: compromising their national pooling of risk, pushing them to take excessive risk, and providing incentives to overcharge borrowers. Utility-like return regulation, on the other hand, would promote the GSEs’ pooling of risk and reduce their incentives to take excessive risk or overcharge borrowers.

National Pooling of Risk to Support GSEs’ Housing Mission

An important function of the GSEs as quasi-insurance companies is to pool risk nationally to diversify credit risk geographically across the country, acquiring loans from about a thousand small and large originators each9 and through the purchase of loans originated in many different years. National pooling of risk supports their charter act mission “to promote access to mortgage credit throughout the Nation (including central cities, rural, and underserved areas) . . . .”10 The GSEs’ national scope provides smaller lenders such as community banks and credit unions with direct secondary market access. Combined with FHFA’s prohibition on volume discounts, this access improves smaller lenders’ ability to compete and better serve their customers and members.11 Pooling of risk is a fundamental insurance function; just as automobile insurers pool the risk of higher and lower risk drivers, the GSEs pool the risk of a variety of borrowers who meet their credit parameters. This approach has increased the flow of credit to all parts of the country. It has created a national mortgage market where all borrowers, from wealthy urban areas to underserved rural towns, pay similar rates and have equal access to the 30-year fixed-rate, prepayable mortgage, providing more affordable, safer loans for borrowers and making homeownership more sustainable. Since the national housing market depends on the widespread ability of households to obtain mortgages so families can sell their homes, choose where they want to live, and have the opportunity to build wealth through homeownership,12 the GSEs’ contributions are important.

While the GSEs engage in some risk-based pricing by charging loan-level price adjustments (LLPAs), their pricing otherwise supports their charter act mission through the efficient use of lower required returns for purchase and rate-term refinance borrowers, particularly those who are low-income or low-wealth. These benefits are estimated to total $4 billion a year.13 At present, most of the ability to charge lower required

The two preconditions for utility regulation that apply to electric companies also apply to the GSEs. First, providing liquidity to the national housing finance market is an essential service. Second, their large economies of scale, the statutory requirement to serve the entire nation, and government advantages have resulted in substantial market concentration and a duopoly.
returns comes from the GSEs' pricing of investor and cash-out refinance loans higher than their credit risk would indicate, which permits the GSEs to improve pricing for families buying a new house or obtaining a less expensive refinance mortgage on their existing house.\textsuperscript{14} The source and amount of benefit can vary over time.

However, if the two GSEs exit conservatorship without any constraints on their ROE, they will have the incentive to charge the highest guarantee fees that the market will bear. As a result, there would be a substantial risk that each GSE would pursue low-risk, high-return business at the expense of the existing benefits to low-, moderate-income, and other underserved borrowers, including those served by smaller lenders in rural areas of the country. This could occur by each GSE pursuing more high-return business, such as investor loans, by pricing these loans slightly lower than they are priced currently, which would necessarily require them to increase the pricing for their lower-return, higher-mission business, raising prices on American homebuyers.\textsuperscript{15} Such pricing incentives would undercut the goal of ensuring that all borrowers across the country, low-income and low-wealth families in particular, are adequately served.

On the other hand, if the GSEs exit conservatorship as return-regulated utilities, their nationwide mission support would continue. The GSEs would have the incentive to maintain their national pooling of risk and efficient use of lower-than-target returns. The benefit of lower ROE requirements is most pronounced for low-income and low-wealth families, as well as rural and disaster-affected areas. This is because the minimum capital required for borrowers with lower credit scores and down payments is substantially higher than those for high-wealth families. A utility structure where GSE management would seek ROEs sufficient but not excessive to attract equity investors would, therefore, keep the level of guarantee fees/LLPAs as low as possible for these families. Conversely, the borrowers least able to bear increases in guarantee fees would be the ones that bear the brunt of increases in a no return constraints approach.

**Continuing the GSE Low-Risk Business Model**

In the absence of some regulation of their returns, the GSEs would set more aggressive ROE targets, which would in turn drive them to take greater risk in order to meet those targets. Given the taxpayer’s assumption of stress losses beyond their capital requirements, this would create a dangerous dynamic, indeed precisely the dynamic that helped lead them into conservatorship in the first place.

Before conservatorship, the GSEs’ targeted rates of return were unchecked and were considerably higher than their implicit ROEs today, generally over 20% from 1992–2003, and Fannie Mae’s were 16.6% in 2004 and 19.5% in 2005.\textsuperscript{16} Predictably, as a result, they took on entirely too much risk. They leveraged their balance sheets to invest in subprime private-label securities, expanding their retained portfolios to $1.6 trillion combined. And they held all of the credit risk (beyond that covered by mortgage insurance companies and a few other credit enhancers) on trillions of dollars of guaranteed mortgages. Their underwriting and quality control processes were inadequate. Driven by their need for growth to achieve high target ROEs, they aggressively chased market share even as the market went into riskier and riskier territory, such as no documentation Alt-A loans. Their minimum capital standards of 0.45% for off-balance-sheet MBS guarantees were woefully inadequate, leaving the guarantee fees they charged much too low to cover their risks.

Today, by contrast, the GSEs sell virtually all their interest rate and liquidity risk to MBS investors and three-quarters of their credit risk to credit protection investors.\textsuperscript{17} Their underwriting and quality control practices have been substantially improved, the capital they will be required to hold is more than five times higher than before,\textsuperscript{18} the guarantee fees they charge to absorb losses are more than two times larger than
before the crisis,\textsuperscript{19} and they are overseen by a regulator equipped with the necessary authorities.\textsuperscript{20} Further, the GSEs are limited to purchasing Qualified Mortgage loans, which exclude the no- and low-documentation, interest-only, negatively-amortizing, and teaser-rate adjustable mortgages that caused substantial losses in the private-label securities market and to the GSEs in the wake of the crisis.\textsuperscript{21}

In contemplating an exit from the GSEs’ conservatorship, FHFA should choose the approach that best supports the continuation of their current low-risk business model and best guards against a return to past risky practices. As a result of their high ROEs before the crisis, the GSEs attracted growth-oriented investors who demanded these high returns. If FHFA and Treasury choose the no return constraints approach even though the GSEs do not operate in a truly competitive market, the GSEs’ management would have the same set of incentives that they had before conservatorship. It would be difficult for these incentives not to influence management as they strive to maximize ROE and shareholder returns.

The best ways to continue to reduce the systemic risks associated with GSEs’ monoline and highly correlated business models are through establishing strong minimum capital requirements that would ensure that the GSEs survive another 2008-type crisis and remain going concerns; continuing to transfer the majority of their credit risk to a well-diversified group of private credit protection investors; continuing to limit retained portfolio activities; and establishing a utility-like rate of return regulatory process.

Utility-like regulation would see the GSEs employ a more cautious dividend policy during periods of economic growth and strong house price appreciation, which would better prepare them for inevitable downturns. Such regulation would prevent the GSEs from underpricing their guarantee fees below the amount necessary to cover their risks in order to gain market share, which can be a prelude to raising prices, since ROEs would fall below FHFA’s permitted band. It would also reduce the incentives for the GSEs to pursue activities currently undertaken by other firms seeking to meet their shareholders’ expectations for higher revenue growth.

Such regulation would favor long-term low risk/return value investors over higher risk/return growth investors and substantially reduce the ROE-maximizing/risk-taking pre-conservatorship business model of the GSEs. Investors should have greater confidence that the GSEs would stick to their mortgage credit guarantee missions without the temptation to engage in risky activities, reaching to satisfy growth investors’ high returns. Under a utility regime, investors would likely view the GSEs as value-focused companies with sustainable dividend capacity, which would attract investors seeking long-term, stable returns, such as pension funds and insurance companies.\textsuperscript{22} Investors would thus accept utility-level returns on capital that would likely be lower than for competitive markets, keeping guarantee fees and, therefore, mortgage rates as low as possible while sufficient to cover the GSEs’ risks. Ultimately, though, private market shareholders still determine what returns would be required in order to invest the necessary amount of capital in the GSEs. FHFA would need to be careful not to set return targets too low so that the GSEs are able to attract sufficient private investment capital.
Ensuring that the GSEs Do Not Overcharge Borrowers

One of the dangers of an oligopoly, in particular a duopoly, is that so few players in the market can easily lead to collusion over pricing, even if only implicitly, as both are better off if they raise pricing in sync. This is the market pricing power that drove the utility regulation of the electric power industry. Continuation of FHFA’s de facto utility regulation would ensure that mortgage rates do not rise unnecessarily for American homeowners across the board.

How Utility Regulation Works in Practice

Given the combination of essential service and market concentration, the government and the electrical company enter what is called a “regulatory compact.” As stated in a primer on utility regulation:

Effectively, regulation constitutes an agreement between a utility and the government: the utility accepts an obligation to serve in return for the government’s promise to approve and allow rates that will compensate the utility fully for the costs it incurs to meet that obligation.23

Under this type of regulation, the government, through a state-level commission, first determines the eligible assets (called the “rate base”) on which a return can be earned. For electric utilities, about 90% of these assets are composed of fixed assets such as generator plants and transmission lines.24 These assets are funded by a combination of debt and equity, usually about half of each. The cost of debt is clear and determined by the market. The main task of the commission is to establish the allowed ROE that can be earned through the company’s rates, which is “the return that the utility must offer to investors to get them to invest in the company.”25

Because these utilities depend on private investment, they must be permitted to provide sufficient returns to their investors. Again, the primer is useful here:

Utilities are allowed the opportunity to earn a regulated annual rate of return on their rate base. Legal precedent requires that rate to be sufficient to allow the utility to attract additional capital under prudent management, given the level of risk that the utility business faces. Two key US Supreme Court decisions . . . set out the general criteria that commissions must consider when setting rates of return. . . . In Bluefield, the Court found that utilities are entitled to a fair return, but not the kind of return that investors in speculative or risky ventures expect to receive.26

While utilities receive the opportunity to recover a fair return, they are not guaranteed this return.27

Typically, expert witnesses provide extensive testimony and analyses in rate-case proceedings to help establish the permitted ROE using methodologies such as discounted cash flow analysis, capital asset pricing models, bond yield-risk differentials, and earnings by comparable companies.28 Ultimately, the allowed ROE is “determined by the exercise of regulatory judgment that takes all evidence into consideration.”29

Once the cost of equity capital is determined, the commission can determine the overall cost of capital based on the weighted average cost of the utility’s debt and equity. It then multiplies the eligible assets
Treat Fannie and Freddie as Utilities

gainst the overall cost of capital to determine the amount of revenue that must be paid for through the rates that the utility charges its customers. The commission also permits the utility to recover its prudent operating expenses incurred in providing the electricity. The revenue necessary to cover the cost of capital plus the operating expenses determine the utility’s “revenue requirement.” The utility then establishes rates for the upcoming year that permit it to recover the revenue requirement. While establishing the permitted equity return is often a disputed process, the controversy generally revolves around a relatively narrow range.

Utility regulation of the GSEs would work similarly. Instead of a state-level commission, however, FHFA would be the entity to determine allowed returns on equity. And instead of eligible assets being largely composed of fixed assets to generate and distribute power, they would largely be financial assets.

Although it is not well-understood, FHFA already currently oversees the GSEs as return-regulated utilities. Today, FHFA establishes a target band for the GSEs’ overall implied ROE, in combination with FHFA’s capital standard, and routinely reviews GSE returns to determine whether guarantee fees charged to lenders are at an appropriate overall level.

FHFA sets the minimum capital standard that the GSEs must hold against the risk they are taking on. This capital standard is currently a measure of implicit capital, not actual capital, since FHFA and Treasury have restricted the ability of the GSEs to hold capital. FHFA currently subjects the GSEs to the capital rule it proposed in 2018, although it has announced that it will re-propose this rule. Once FHFA finalizes its capital rule, that standard would apply to the GSEs.

FHFA uses the capital requirements and revenues to calculate an implicit ROE both for new business acquisitions and for the GSEs’ total single-family credit guarantee book as a whole. FHFA evaluates these implicit ROEs against an FHFA target ROE band to ensure that the ROEs are high enough to approximate what equity investors would require to cover the GSEs’ risks but not too high so that they are overcharging borrowers.

And then FHFA compares the actual implicit GSE ROEs and the target ROEs to adjust the guarantee fees as necessary. If the implicit ROE falls within FHFA’s target band, then FHFA determines that guarantee fees are priced appropriately. If the ROE regularly falls below the target ROE, then FHFA would require the GSEs to raise their guarantee fees. Conversely, if the ROE regularly exceeds the upper bounds of the band, the GSEs would move to reduce guarantee fee levels.

The process of establishing an appropriate ROE range is crucial because the most important component by far in determining the level of guarantee fees that the GSEs charge lenders, and that borrowers pay through their mortgage rates, is the cost of capital, which is the product of the amount of capital and the pre-tax return earned on that capital. Most observers would agree that FHFA’s utility-like regulation of the GSEs in conservatorship has worked well to prevent the GSEs from underpricing their guarantee fees to maximize market share or from using their market power to overcharge guarantee fees.

FHFA could easily continue its return regulation of the GSEs outside of conservatorship. FHFA and the GSEs have substantially more market pricing information available that shows the market’s estimate of risk and required returns to guide FHFA’s decision than is available to electric companies, simplifying the return-setting process. Initially, as it does today, FHFA would review ROEs for large financial institutions taking on similar risks, such as large banks and insurance companies as well as REITs, although shareholder returns for these competitive markets would likely be higher than for the GSEs regulated like utilities.
The credit risk transfer (CRT) market is currently liquid enough that there is active re-trading of CRT bonds, which, along with reinsurance and other forms of credit enhancement, provide FHFA market feedback on pricing GSE credit risk and private market returns. FHFA could consult with Wall Street investor analysts to inform equity returns. Ultimately, a public offering outside of conservatorship will illuminate the par yield dividend rate, which will assist in providing the necessary ROE guidance. FHFA would need to go through a more formal and public process to establish an appropriate ROE band than it has done to date.

FHFA would continue to be the final decision maker regarding the appropriate capital, revenues, and returns. Congress could certainly enact legislation, either before the GSEs exit conservatorship or afterward, to establish a regulatory commission for determining the ROE band for the GSEs to more closely mimic state regulation of utilities, but such a commission would not be required and may prove more difficult to administer.

As described in the process for establishing permitted ROEs for electric utility regulation, the selected ROE band would need to be high enough to attract equity investors but not higher than necessary. FHFA could establish an annual process of determining the appropriate ROE band. As part of its promotion of pooling of risk nationally, FHFA would evaluate just the overall ROEs and leave it to the GSEs to establish the ROEs for each of their credit score/loan-to-value and product-level segments.

FHFA would also permit the GSEs to pass on expenses. These expenses would include their general and administrative expenses and credit-related charges, such as expected losses. The GSEs would also be permitted to pass on their CRT expenses. Under this program, the GSEs pay a portion of their guarantee fees to private investors to take responsibility for a substantial portion of the credit losses in the mortgages the GSEs acquire, thereby reducing the GSEs’ need for shareholder capital. Finally, the GSEs would be permitted to pass on the cost of the government support, a periodic commitment fee established through the PSPAs.

In sum, guarantee fees (revenues) should be sufficient to recover the cost of capital, which depends on the required minimum amount of capital, as determined by FHFA’s final capital rule, and the ROE, which would be evaluated against FHFA’s established band, plus the GSEs’ expenses.

FHFA could adopt the utility regulation framework for the GSEs as consideration for amending the PSPAs, taking actions to facilitate the GSEs exiting conservatorship, and providing the explicit PSPA government support outside of conservatorship, as well as to promote their safety and soundness.

FHFA’s authority to continue its return regulation practice outside of conservatorship should be made explicit when FHFA and Treasury permit the GSEs’ exit, whether the provision is part of PSPA amendments or through separate agreements between the GSEs and FHFA. FHFA, as a regulator of two GSEs, and Treasury, as a major investor in the GSEs and its guarantor through the PSPAs, have legitimate interests in ensuring that the GSEs use that government support to carry out their statutory duties and that they do so without taking excessive risks that put the government in danger. The return regulation construct is important to accomplish both objectives.
Conclusion

If Treasury and FHFA release the GSEs from conservatorship, they should continue the return-regulated approach FHFA has used effectively in conservatorship. Utility-like regulation would allow the GSEs to continue to operate at low risk and in a way that provides broad access to affordable mortgage credit nationwide. Removing that check on GSE returns on equity would lead to greater risk and less systemic stability, less pooling of risk and access to credit, and higher prices for America’s homebuyers.


The reasons for this are numerous: housing finance is a very complicated issue, risks are high since housing is such a large component of the economy, there is no current crisis spurring legislation, there are ideological divisions about the role of the GSEs, and Congress has had difficulty enacting legislation of any sort in recent times.

The various iterations of the PSPAs are available at https://www.fhfa.gov/Conservatorship/Pages/Senior-Preferred-Stock-Purchase-Agreements.aspx. See US Department of the Treasury Housing Reform Plan at p. 13.


Jim Lazar, Electricity Regulation in the US: A Guide. Second Edition, The Regulatory Assistance Project (July 12, 2016), at p. 6, available at https://www.raponline.org/knowledge-center/electricity-regulation-in-the-us-a-guide-2/. Until the 1990s, the great majority of electrical customers were served by investor-owned, vertically-integrated monopoly utilities. Between 1995 and 2002, some parts of the country went through restructurings that removed certain parts of the utilities’ business lines from being monopolies, such as power generation. Even in these states, utilities have maintained their monopoly transmission and distribution function since it does not make sense to have two parallel sets of transmission wires. Severin Borenstein and James Bushnell, The U.S. Electricity Industry after 20 Years of Restructuring, National Bureau of Economic Research (April 2015) at pp. 1–3, available at https://www.nber.org/papers/w21113.


12 USC 1716(4).


See Christopher Herbert, Daniel McCue, Rocio Sanchez-Moyano, Update on Homeownership Wealth Trajectories Through the Housing Boom and Bust, Working Paper: Joint Center on Housing Studies of Harvard University (February 2016) at p. 6 (stating that “e]ven after the precipitous decline in home prices and the wave of foreclosures that began in 2007, homeownership continues to be associated with significant gains in household wealth at the median for families of all races/ethnicities and income levels. Households who are able to sustain homeownership over prolonged periods...
stand to gain much. Meanwhile, renters experienced little wealth accumulation over this period. And though homeownership is certainly not without risk, the typical renter household who transitioned into and then exited homeownership by 2013 was no worse off financially than the typical household who remained a renter over the whole period.

13 See Laurie Goodman, Jim Parrott and Mark Zandi, The Trump Administration's Perplexing Plans for Fannie and Freddie, Urban Institute (October 30, 2019) at p. 5, available at https://www.urban.org/research/publication/trump-administrations-perplexing-plans-fannie-and-fredde. These estimates do not include the benefits provided by the GSEs to middle income borrowers in rural areas, small and mid-sized towns, or in areas affected by national disasters.


15 Housing goals and duty to serve requirements on the GSEs would provide a degree of counterweight, though the financial goals of the GSEs provide the largest incentives.


17 According to FHFA, “Through the first half of 2019, Fannie Mae and Freddie Mac transferred 84 percent and 89 percent, respectively, of the allocated credit risk capital on 2018 acquisitions covered by credit risk transfer. Of the total single-family loan acquisitions of the Enterprises in 2018, 73 percent were targeted for credit risk transfer. Since the start of the CRT programs in 2013 through the end of June 2018, the Enterprises have transferred a portion of credit risk on approximately $3.1 trillion of unpaid principal balance (UPB) with a combined Risk in Force (RIF) of about $102 billion, or 3.3 percent of UPB.” News Release, FHFA Updates Progress on Fannie Mae and Freddie Mac Credit Risk Transfer Programs (November 12, 2019), available at https://www.fhfa.gov/NewsCenter/PublicAffairs/Pages/FHFA-Updates-Progress-on-FNM-and-FRE-Transfer-Programs-111219.aspx. According to Freddie Mac, including the loans not targeted for CRT, “FHFA’s conservatorship capital needed for credit risk was reduced by approximately 75% through CRT transactions on new business activity in the twelve months ended September 30, 2018.” 2019 Third Quarter 10-Q (October 30, 2019) at p. 20, available at http://www.freddiemac.com/investors/financials/pdf/10q_3q19.pdf.

18 The GSEs' combined capital requirement in FHFA's proposed rule for 2017 was 3.24%, which is 7.2 times higher than the 0.45% required for MBS before conservatorship. GSE risks have continued to fall since the rule was issued and FHFA's final rule requirements are unknown, so we conservatively state that capital requirements are more than 5 times higher. See Fact Sheet: Proposed Rule of Enterprise Capital (June 12, 2018) at p. 4, available at https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/Proposed-Rule-Ebere-capital-Fact-Sheet.pdf.


20 The Office of Federal Housing Enterprise Oversight (OFHEO) was the GSEs' regulator prior to the passage of the Housing and Economic Recovery Act of 2008 (HERA). OFHEO lacked important regulatory authorities. Most notably, its budget was subject to annual appropriation by Congress, which meant that it lacked necessary resources as well as the independence to be an effective safety and soundness regulator. HERA rectified the situation by creating FHFA and providing it with authorities and independence comparable to other federal financial regulators like the Office of the Comptroller of the Currency, which regulates national banks.

21 See Mark Zandi, Gus Harris, Ruby Shi, and Xinyan Hu, Who Bears the Risk in Risk Transfers, Moody's Analytics (August 2017) at Table 1, p. 2 (from 2006 to 2014, GSE loans realized losses of 3.1 percent of their outstanding balance at the start of the crash, year-end 2007, while private-label securities faced losses of 24.2 percent and depository institution portfolio loans had losses of 6.3 percent), available at https://www.economy.com/mark-zandi/documents/2017-08-02-who-bears-the-risk.pdf. It was the GSEs' late entrance into purchasing Alt-A no documentation loans and also buying non-QM-compliant subprime mortgage-backed securities that caused their significant credit losses during the crisis. In 2008, for example, Alt-A loans comprised 45.6 percent of Fannie Mae's single-family guarantee credit losses,

22 Thanks to Tom Parent for this phrasing.


26 Ibid. at p. 53. As North Carolina's statute reads, the commission's job is to "[f]ix such rate of return . . . as will enable the public utility by sound management to produce a fair return for its shareholders, considering changing economic conditions and other factors . . . and to compete in the market for capital funds on terms that are reasonable . . . ." N.C.G.S. Section 62-133(b)(4).

27 *Basic Ratemaking: Key Concepts* at p. 27.


31 Ibid. at p. 56; see Heather Payne, *Game Over: Regulatory Capture, Negotiation, and Utility Rate Cases in an Age of Disruption*, University of San Francisco Law Review (2017) at p. 86 ("A better way to determine revenue and profits has not yet been determined."); available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3025917&download=yes.

32 This paper examines just the GSEs’ single-family business lines, which are by far their largest.

33 In 2012, FHFA and Treasury instituted a “sweep” of all GSE net income beyond a small buffer. See Third Amendment to the PSPAs (August 17, 2012), available at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Senior-Preferred-Stock-Agree/FNM/SPSPA-amends/FNM-Third-Amendment-to-the-Amended-and-Restated-SPSPA_08-17-2012.pdf. FHFA is currently in the process of permitting the GSEs to build their capital levels.


35 Freddie Mac reports that its imputed ROE is currently 14.4% based on FHFA’s capital requirements, although it further states that “[o]ur belief, should we leave conservatorship, is that returns at that time would most likely be below the levels calculated above, assuming the same portfolio of risk assets, as we expect that we would hold capital post-conservatorship above the minimum required regulatory capital. It is also likely that we would be required to pay fees for federal government support, thereby reducing our total comprehensive income.” See 2019 Third Quarter 10-Q (October 30, 2019) at p. 47, available at http://www.freddiemac.com/investors/financials/pdf/10q_3q19.pdf.


37 Thanks to Richard Cooperstein for this point.

38 This fee would be set by FHFA, on the GSEs' behalf, and Treasury, with consultation with the Chairman of the Federal Reserve, while the GSEs are still in conservatorship. Third Amendment to the PSPAs (August 17, 2012) at p. 5. Outside of conservatorship, the GSEs would need to agree to any changes in the fee levels.

39 The fact that FHFA oversees just two GSEs with PSPA support is why it would be appropriate that it has utility return regulation authority while, for example, the regulator of over a thousand national banks and savings associations, the Office of the Comptroller of the Currency, would not.
The Center for Responsible Lending (CRL) is working to ensure a fair, inclusive financial marketplace that creates opportunities for all responsible borrowers, regardless of their income, because too many hard-working people are deceived by dishonest and harmful lending practices.

CRL is a nonprofit, non-partisan organization that works to protect homeownership and family wealth by fighting predatory lending practices. Our focus is on consumer lending: primarily mortgages, payday loans, credit cards, bank overdrafts, and auto loans.