MEMORANDUM

To: **Adolfo Marzol, Principal Deputy Director, FHFA**
Jonathan McKernan, Senior Counsel for Policy, FHFA

From: **Mike Calhoun, Center for Responsible Lending**
Richard Cooperstein, Andrew Davidson & Co., Inc.
Ken Fears, National Association of REALTORS®

Date: **February 25, 2020**

Re: **Recommendations regarding the capital rule for Fannie Mae and Freddie Mac**

- **Regulate the GSEs as utilities by limiting their overall ROE to a target band sufficient to attract the necessary private investment capital**
    - Utility regulation is FHFA's current de facto practice in conservatorship and is working extremely well.
        - The GSEs now intermediate a substantial majority of their interest rate/liquidity and credit risk with unbeatable efficiency. This is crucial for price discovery, competitive discipline, and reducing both consumer cost and taxpayer risk.
        - FHFA establishes capital requirements and an ROE target band that together ensure that guarantee fees are neither too low nor too high. The implied cost of funds now being used is reasonable for competitive markets but probably higher than would be required for well-structured utilities.
    - This regulatory framework should continue outside of conservatorship to maintain the GSEs' low-risk business model.
        - Helps ensure the GSEs do not exploit their franchise outside their mission.
        - Protects against underpricing to gain market share.
        - Reduces incentive to engage in risky behavior to obtain outsized returns to pressure to grow earnings.
        - Protects against overpricing through duopoly collusion.
    - Investors would view GSEs as value stocks with sustainable dividend capacity, requiring lower ROEs.

- FHFA would have market-determined pricing indicators to guide it in establishing an appropriate ROE band for its guarantee fees from CRT spreads and effective dividend yields.
  - The CRT bond market, which includes active re-trading, reinsurance panels, and other forms of private credit enhancement, provide market pricing and return information.
  - Wall Street equity analysts' perspectives shed light on appropriate returns for equity investors.
  - The returns generated by other large financial institutions facing similar risks, such as large banks, insurance companies, and REITs, are useful comparables. However, all these are competitive markets where shareholder returns would have to be higher than for the GSEs as utilities. In addition, FHFA capital regulation more effectively accounts for credit enhancements that reduce credit exposure than other regulated segments.
  - A public stock offering will illuminate the par yield dividend rate, which provides the cost of equity. This combines with CRT funding cost to determine GSE cost of capital.
- Utility regulation would see the GSEs employ a more cautious dividend policy during periods of economic growth and strong house price appreciation. Utility rate of return regulation would provide a natural limit to realized returns, since the only major variability would be in the level of expected losses.

- **Count guarantee fee income toward total risk-based capital requirements**
  - Guarantee fees provide an important and reliable source of loss absorbing capacity that should not be ignored; fully 92% of GSE borrowers stayed current on their loans even through the crisis, and servicers advanced the fees on the remaining 8%. Further, guarantee fee payments are top of the waterfall of mortgage interest payments from loans to net MBS coupon. If fees had no impact on required capital, then the same amount of paid-in capital would be required if guarantee fees were 5 basis points or 500 basis points, which is illogical.
  - The GSEs could create and sell interest-only strips of guarantee fee revenue where the proceeds could count toward capital; GSE Trust IO have been created many times to monetize some portion of the borrower's mortgage interest payment. Ignoring these fees in capital calculations encourages the GSEs to create IO securities and bear the deadweight transaction costs. Regulations that are counter to economic reality lead to countering behavior that is certainly less efficient and can have unintended consequences. Guarantee fees will be monetized; it will be preferable for FHFA to control how.

  - Guarantee fee income used to purchase loss protection through CRT transactions appropriately reduces paid-in capital requirements, but guarantee fees directly available to cover losses do not.
  - Bank capital requirements recognize revenue through the Dodd-Frank stress tests.
  - Since guarantee fees provide an offset to losses, preserving capital, they should count toward capital requirements.
    - At minimum, two- or three-years' worth of guarantee fees, roughly half a reasonable multiple, less general and administrative expenses should count. If guarantee fees are 47 basis points and G&A expenses 7 basis points, fee income could cover requirements of 80 to 120 basis points (40*2 or 40*3) of capital requirements.

- **Additional issues**
  - **CRT and capital**
    - We believe that FHFA should consider equity-equivalent CRT as a component of capital rather than a reduction in the amount of capital required for risk-based capital purposes. This more transparently communicates the amount of risk the GSEs are taking on and how this risk will be addressed.
    - Thus, the requirement for credit risk capital would be as if there were no risk transfer occurring. Approved CRT transactions (discounted for counterparty risk, attachment/detachment points, length of coverage, etc.) would count toward that capital requirement.
  - **Count expected losses as a component of capital**
    - Similar to PMIERs, total capital should be the combined total of CECL/expected losses and unexpected losses for risk-based capital purposes, leaving paid-in capital requirements the same.
  - **Leverage ratio**
    - Capital should reflect risk, and averaging across different risk assets distorts incentives. Thus, the leverage ratios for MBS trust assets and retained portfolio assets should be different: for example, 1.5% and 4.0% respectively. The 2.5% average requirement distorts incentives, raises risk and makes the regulator's job more difficult.
    - The guarantee fee income, equity-equivalent CRT, and expected losses that should be included in the risk-based capital requirement apparently cannot be a part of the leverage ratio by statute. To ensure that the risk-based capital measure appropriately remains the binding constraint, FHFA

should take that fact into account in setting the leverage ratio lower than it otherwise would have.