

EXECUTIVE SUMMARY

GSEs: Their Viability as Public Utilities

February 1, 2021

Overview:

The following summary outlines the conditions under which a market utility can, at all times, maximize competition and the use of private capital while supporting market liquidity for both a national market and underserved communities. For more information, read the full comprehensive examination of this issue: [GSEs: Their Viability as Public Utilities](#).

Abstract:

In the spring of 2019, NAR joined financial market experts Susan Wachter and Richard Cooperstein to propose transitioning Fannie Mae and Freddie Mac (Enterprises) into market utilities - [A Vision for Enduring Housing Finance Reform](#). The Enterprises have worked well since the Great Recession and NAR's plan locks down this structure for the future in a way that improves access to mortgages while maintaining market stability.

In their latest white paper, *GSEs: Their Viability as Public Utilities*, the authors further clarify several points in the discussion of a mortgage market utility.

Will investors come given utilities' lower returns, and under what conditions?

The answer is yes and here's why:

- Not all investors want high growth stocks. Many, like insurance companies and large retirement funds, want stable dividends that they can rely on to make their own payments such as life insurance policies. They will accept lower returns in exchange for stability. These investors have a long-view that provides the stable funding that will meet both the Enterprises' mission of stability and market support. It is in these investors' interest not to take risks for short-term gain, but to keep the ship steady through the cycle to earn steady, stable returns.
- To achieve stability, all risks in Fannie Mae and Freddie Mac and their business must be understood, transparent, and minimized. In addition, the government's support for the companies' role in the market and explicit government guarantee of the MBS they produce must be made clear. Finally, the regulator must be strong enough to see through and manage the tensions with the market, shareholders, consumers, and taxpayers.

Why a Utility?

- Fannie Mae and Freddie Mac are not typical companies. They have historically had shareholders and therefore must defend their profits. Shareholders take losses before taxpayers and are incentivized to run a good business.
- However, Fannie and Freddie are chartered by Congress to maintain liquidity at all times across the country and to support underserved markets. They get special treatment to perform this function.
- Thus, Fannie and Freddie have to satisfy two important groups: shareholders and taxpayers.
- Fannie and Freddie are central to the industry as they provide the infrastructure, maintain critical functions for the market to survive, and carry out a public service.
- The market they operate in is not naturally competitive and could lead to bad outcomes such as over pricing, restricted access, low quality products for investors, and risky behavior.



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- Since the Great Recession, Fannie Mae and Freddie Mac have been reformed to be safer and operate more like utilities. They could not have helped the country out of the recession or during the pandemic if they were not structured this way.
- Without them, rates would be higher in normal times, access would decline, and the 30-year fixed rate mortgage would not be widely available.
- Locking them down in their current state as market utilities presents the least risk of all options. The Treasury, FSOC, and FHFA will make changes after which Congress amends a few laws, no big changes!

As market utilities, Fannie and Freddie strike a balance between utilizing private capital to protect tax payers, incorporating market incentives and innovation, and fulfilling their charter mission to the market and consumers.

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Introduction

In the spring of 2019, the National Association of REALTORS® (NAR) joined co-authors Susan Wachter, the Albert Sussman Professor of Real Estate, and Professor of Finance at The Wharton School of the University of Pennsylvania, and Richard Cooperstein, Director of Alliances and Policy at Andrew Davidson & Co., to pen [A Vision for Enduring Housing Finance Reform](#). Here, we proposed the simplest and most durable way to lock down Fannie Mae and Freddie Mac (the GSEs or Enterprises) in their current form as systemically important mortgage market utilities, or SIFMUs. While the concept of making the Enterprises utilities existed for years, the *Vision* explains why this system makes sense today in light of the industrial organization of the primary and secondary markets. Ultimately, this approach will allow America’s housing finance system to execute its congressionally-chartered mission and to support a national mortgage market, especially in a crisis like the great recession or pandemic, by retaining market incentives and protecting taxpayers.

NAR has once again joined Dr. Wachter and Dr. Cooperstein to pen [GSEs: Their Viability as Public Utilities](#). This succeeding article to the *Vision* answers the fundamental question that has mired the utility concept outlined in the *Vision* - - whether the SIFMU can effectively compete in the marketplace and attract equity investors at the lower returns of a utility. In resolving this question, the *Centerpiece* demonstrates that under



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reasonable conditions, a well-structured, regulated utility can indeed attract investors while advancing fairness and competition in ways that private companies never could.

A core principle of the market utility is that the mission-centric focus is balanced against competitive market necessities by requiring the SIMFUs to sell off most of their risk to private investors in markets that the SIFMU create and manage, enabling them to maintain market discipline, bring private capital to bear, and protect taxpayers. Focusing the federal role on regulation and oversight of the Enterprises, while providing a catastrophic backstop, crystalizes the respective roles of the Enterprises and their regulators, building on the wide and long history of the market for regulated utilities.

The subtle importance of the *Centerpiece* is that it is not arguing for a new system. Rather, the current system of utility-style market support which has been enjoyed for the last decade is tenable outside of conservatorship if the right preconditions are met; investors will come, consumers and investors can be protected, and the path of a market utility is the least disruptive and most sustainable way to cement what works today.

Why a Utility?

The Enterprises were chartered by Congress to provide liquidity for a national mortgage market, both in good times and in bad, and to underserved markets. The enterprises carry out this function by purchasing mortgages from originators across the country and bundling them into mortgage backed securities (MBS) and credit risk transfers (CRT), and providing a guarantee to investors who buy the MBS knowing they will receive their payment even if the consumer defaults. The Enterprises are extremely efficient at this process and do so in massive volumes which makes their MBS and CRT among the most liquid investments in the world. Investors accept lower returns for these extremely liquid securities, which in turn lowers costs for borrowers, provides extra profits to support research, and supports a national market. The Enterprises have repeatedly demonstrated their central responsibility in the market during economic stress and their ability to maintain market standards through a sizable footprint in good times.

Holding both rate risk and default risk is dangerous for banks and securitization allows the GSEs to separate the two risks. Under conservatorship, the Enterprises drastically reduced holdings of their own MBS and created the market for mortgage credit risk transfer that now lays off the credit risk on more than \$3 trillion of MBS and growing to private investors. Thus, the Enterprises developed and manage the infrastructure of these markets, externalizing credit and rate risk to markets where hundreds of investors compete while also deepening investor demand by minimizing production risk and providing a quality guarantee.

The traditional role of a utility is to provide for competitive outcomes in markets that lack competition, particularly in markets that provide an important public good like market



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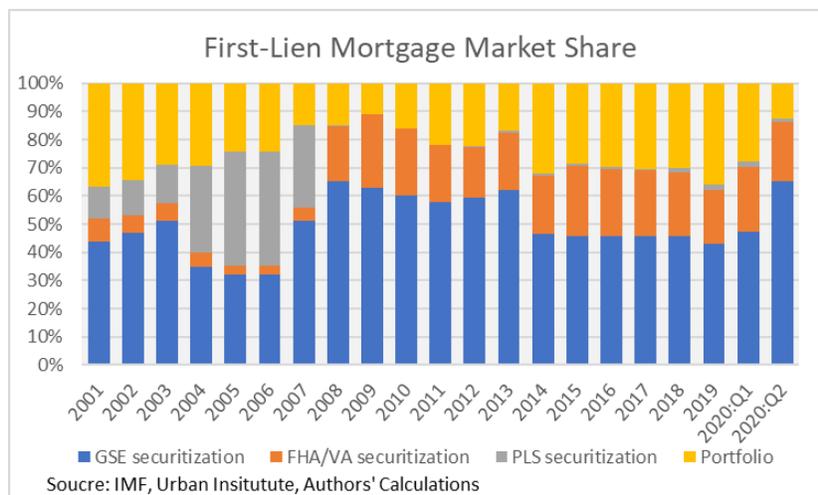
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liquidity. Because the nature of mortgages separates the default consequences by several years from the act of originating loans, the producers of MBS and guarantees could pass-on risks to investors and not bear the consequences of their actions. When unchecked, this has repeatedly led to destructive competition in credit standards and pricing, redlining, and destabilizing waves of mortgage defaults, all to the detriment of consumers and the economy. Furthermore, the cost to maintain infrastructure and manage the risk of producing MBS creates a high barrier to entry, limiting the number of true competitors to the market-making Enterprises that are sustainable. Without structured competition in the form of a utility, new entities could collude, lowering prices to push out new competitors, while raising prices as market power permits and reducing the quality and quantity of capital available for mortgage investments. Utilities are a time-tested way to provide economic services in markets where pure competition does not work. They are a sensible blend of the purely public and private sectors that supports widespread stability and increases middle-class ownership.

How the Enterprises as Market Utilities Enhance Competition

The Enterprises are often depicted as a duopoly. However, given that the Enterprises' market share covers only about half of the market, there is clear competition from the FHA, VA, and RHS. In addition, more than 5,000 entities such as banks, credit unions, REITs, insurance companies, and others originated and guaranteed or held loans in portfolio in 2019. As discussed in detail in the full [paper](#), a Herfindahl index of the industry for 2019 suggests that the industry is very competitive. This analysis does not account for the thousands of investors who compete in the markets for credit and rate risk managed by the Enterprises. In supporting these markets, the GSEs intermediate nearly all rate risk and about half their credit risk from the mortgages they bundle into the private capital markets, while the FHFA regulates shadow equity and return thresholds. These MBS and CRT markets are competitive and efficient enough for the Enterprises' market share to range from 40% to 70%; tellingly higher during recessions and lower in stable and growing markets.



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Indeed, under conservatorship over the last twelve years, the FHFA forced the Enterprises to significantly raise their guarantee fees to market levels which the Enterprises were unable to do on their own. This process leveled the competitive playing field and improved their capital position while maintaining nearly 50% market share. With the onset of the pandemic, the Enterprises' share surged from 47.1% in the first quarter of 2020 to 65.3% in the second quarter, while bank share collapsed from 30% to 13% – all while the Enterprises developed a national forbearance program, foreclosure moratorium, and early payment default purchase program. The Enterprises could certainly do more if their utility mission were more fully developed. This result places in sharp relief the differences between banks' portfolio funding models and the Enterprises' securitization model with its mission to finance all markets at all times.

SIFMU Returns and Investors

Utilities are designed to remediate the lack of competition or market failures and to provide a public benefit like the Enterprises' charter duties, but can SIFMUs provide returns that will attract investors? Under the current implied conservator capital framework, the Enterprises hold roughly 3% capital and charge guarantee fees with an implied return on equity (ROE) of 12% pre-taxes. That return is similar to what large banks earn who also enjoy federally-backed deposit insurance. Regulated utilities generally have lower returns than competitive companies, which is accompanied by decreased risk. Historical data from Duff and Phelps indicate that the implied returns for the S&P have averaged 5% to 6% above a 3% Treasury average.¹ However, utility returns are typically half as risky as the S&P (e.g. have a beta half that of the market) and their risk adjusted returns above Treasury would be half, or 2.5% to 3%. Thus, the ROE for utilities could be roughly 6 to 8% (e.g. 3%+3%).

The question therefore remains whether investors would accept such returns. Not all investors seek the same thing. Some investors have higher risk tolerances, while others, like life insurance for catastrophic insurers, prefer stable returns. In exchange for carrying out their charter mission, SIFMUs operate in a federally-protected market that makes it more likely they will be able to price adequately for risk and achieve consistent returns. This explicit structure should attract investors who desire stable returns, generally similar to utility investors. The FHFA does not need to dictate these returns either. Simply setting a band with a reasonable floor and ceiling will allow the market to determine the return.

¹ <https://www.duffandphelps.com/insights/publications/cost-of-capital/recommended-us-equity-risk-premium-and-corresponding-risk-free-rates>

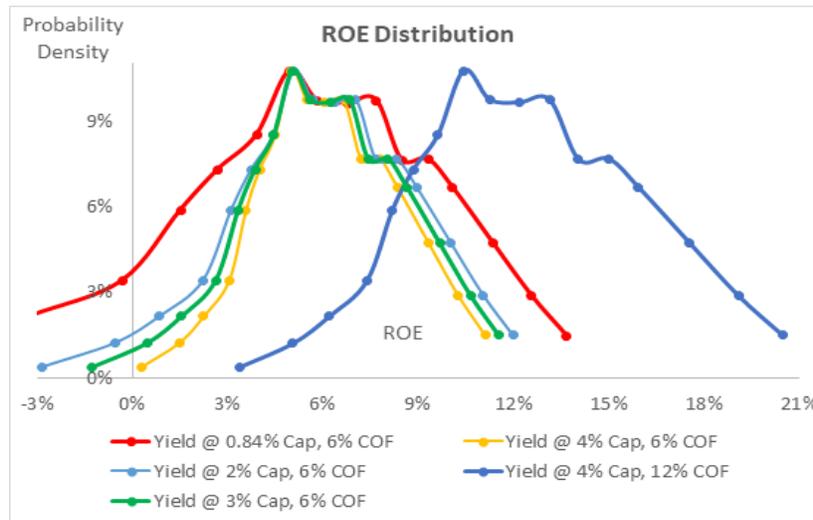


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To determine how a SIFMU might perform over the long-term, the *Centerpiece* employs the Andrew Davidson and Company's (AD&Co.) proprietary model that analyzes the volatility of returns across a variety of economic scenarios. These scenarios include a baseline level of capital to cover all losses in a 2007/8-like crisis and several additional scenarios with buffers that grow in size. These buffered yields ensure the GSEs have the extra liquidity to continue operating through stress events. See Figure 2.



The red line in the chart above depicts the baseline distribution of potential returns for investors using the current GSE portfolio and AD&Co's Capital Charge Method but without any capital buffer. AD&Co's modeled stress losses align with FHFA's published² results and are regularly benchmarked to CRT prices. The model shows that under the baseline 2007/8 event with no buffer, returns for nearly 95% of the total outcomes and shows that returns are positive almost 98 % of the time.³

Next, equity capital is raised to 2% (composed of the 0.84% risk-based capital requirement and a 1.16% capital buffer) and the exercise is replicated. The distribution of returns with 2% capital is displayed in light blue and demonstrates that investors would receive a positive return in nearly all scenarios. Results are shown for progressively larger capital buffers and show predictably tighter return distributions around the 6% probability weighted average return. Finally, the dark blue line depicts a scenario 4% capital at 12% returns, which provides a positive return of 3% or more in all scenarios, a high return when other markets are likely collapsing.

² See FHFA's annual Dodd-Frank Act stress testing results.

³ Based on AD&Co modeling, which is consistent with CRT market pricing and stress losses reported by FHFA. Extreme values have very low probability and are omitted here because they have almost no impact on weighted-average expected returns. The 1% downside event determines capital.



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This exercise illustrates a fundamental question about returns in federal-protected markets; how high should they be? It seems that the government does not need to protect a 12% return. Nor should it be the case that losing money is impossible. Any positive return in a crisis should attract enough investors to maintain quality of production and stability through the cycle. However, anchoring returns closer to zero in a crisis is appropriate to align investor, taxpayer, and charter obligations and this exercise demonstrates that investors will still receive stable utility returns through such a crisis. In summary, utility returns of 6%, 8%, or 10% can provide the stability needed to support equity investors' ROEs. This is critical given the Congressional Budget Office's (CBO) recent analysis that indicates the only way to recapitalize the Enterprises in a reasonable amount of time and appropriate capital, while also maximizing taxpayer value, is with a lower rate of return for investors and strong housing growth, counter to privatization.⁴ Excess fees or capital will only shrink the Enterprises' footprint making this critical task unnecessarily more difficult and undermining their charter duties.

An Effective Structure: Not all Utilities Are a SIFMU

Government control or a congressional charter alone are not sufficient to create a utility that will continue to carry out the mission laid out in the charter and attract private capital. The following preconditions must be met:

- **Convert to SIFMU** – Congress must direct and the Financial Stability Oversight Council (FSOC) must designate the Enterprises as SIFMUs. This clarity of political alignment is crucial to setting investor expectations that the structure of the Enterprises is cemented along with its franchise value. SIFMU entails a waterfall of regulators (e.g. FHFA and the Federal Reserve) with significant powers of oversight. This structure is important as capital is no replacement for transparency and effective regulation and oversight.
- **Explicit, paid-for federal guarantee** – In a crisis, the Enterprises can borrow money from the Treasury to buy mortgages from lenders at low cost to make MBS. Their explicit federal backstop boosts demand from investors and entities from sovereign governments, including the Federal Reserve, to buy Enterprise MBS, reducing costs for consumers in a crisis and providing a steady flow of funds. Furthermore, the government support is an explicit sign to future equity investors that the government will protect their franchise value, the large market share, and time horizon needed to spread the costs of the infrastructure and charter duties. If Congress were to charter additional Enterprises, it would undermine this franchise value and make it harder for the Enterprises to diversify their risks,

⁴ Congressional Budget Office. *Effects of Recapitalizing Fannie Mae and Freddie Mac Through Administrative Actions*. August, 2020. Washington, DC



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jeopardizing taxpayers and market stability. Therefore, an explicit, paid-for federal guarantee must accompany the SIFMUs to protect market liquidity.

- **FHFA Drives Transparency on Regulated Entities and Counterparties** – Investors, taxpayers, and consumers benefit from a system where all risks are transparent and accounted for every step of the way. The inability to quantify risks results in investors requiring higher than necessary returns, which translate into higher costs for consumers. The Enterprises could also skirt their charter duties without appropriate transparency. Congress must empower the regulator of the SIFMU to enforce transparency so that the SIFMUs' investors, buyers of their products in MBS and CRT, and suppliers of mortgages, servicing, and reinsurance or guarantees, and the communities that depend on them for support, can respond to positive and negative behavior by the Enterprises.
- **FHFA Sets a Band for Investor Returns** – Return setting is not necessary for a mortgage market utility. Rate and credit risk, the two main components of guarantee fees, are already set by private investors in markets for MBS and CRT. Furthermore, a large number of firms specialize in analyzing utilities for equity investors. The FHFA must be empowered by Congress to set a floor and ceiling for guarantees that reflects this market information. The guarantee floor allows for competition, while the cap limits their ability to exploit market power or underprice risk as in the past.
- **FHFA Sets Appropriate Capital** – The Enterprises must retain the appropriate amount and type of capital to support market liquidity at all times – particularly during a crisis. This efficiently offloads risk to the private sector while acknowledging their special obligations to the market and their government guarantee.

Conclusion: Build It (the Right Way) and They Will Come

Fannie Mae and Freddie Mac play an indispensable role in the mortgage market. These entities provide the infrastructure and standardization that is the bedrock of the conventional mortgage market and maintain liquidity in the national market at all times while supporting underserved markets. They created and maintain both the markets for Enterprise MBS and CRT, which protect taxpayers, while providing transparency and lower costs. In doing so, the Enterprises have transitioned from hedge funds that held the interest rate and credit risk into market utilities that sell off this risk to investors, insulating the market. The best means to continue this critical role, while protecting taxpayers, is to canonize their current role as SIFMUs. The *Centerpiece* demonstrates that SIFMUs with the correct preconditions will provide stable returns that will attract investors with a long-term outlook, the exact type of investors needed for the Enterprises' enduring and critical role. It is time for Congress and the administration to work together to chart a durable course for the finalization of secondary market reform.

