



June 29, 2023

Federal Housing Finance Agency
Office of Capital Policy
400 Seventh Street, S.W., 9th Floor
Washington, DC 20219

Re: Request for Information Regarding Enterprises' Single-Family Mortgage Pricing Framework

Dear Director Thompson,

We appreciate the opportunity to submit comments on the Enterprises' Pricing Framework and share a few thoughts regarding the consistency between guarantee fee pricing and the capital requirements provided under the Enterprise Regulatory Capital Framework ("ERCF"). Franklin Templeton has an extensive history as investors in the government sponsored enterprises, both as equity investors in the Junior Preferred shares of Fannie Mae and Freddie Mac, and as active market participants in the market for secondary mortgage-backed securities as well as credit-risk transfer securities ("CRT"). As longtime investors, we appreciate the opportunity to provide our views to the Administration and FHFA and to assist in any way that we can.

FHFA requested comments on several topics, and in this letter, we will focus primarily on the target return on capital and the interaction between the level of guarantee fees and the capital requirements as currently outlined in the ERCF. In summary, we make the following observations and recommendations;

- We believe the minimum long-term return on equity capital threshold for the enterprises should be between 11% and 12%.
- We recommend that the risk-weight floors on the enterprises' guarantees be adjusted to reflect the very low risk for low LTV loans (<70% LTV) which represent a majority of the guarantee books, and we recommend these be scored based on current rather than original LTV ratios.
- Based on pro forma earnings power and the level of capital required under the ERCF, we believe that Fannie Mae is expected to earn ROE's of between 7.1% and 9.5%, which falls 2.0% to 4.4% below target ROE levels.
- For Freddie Mac, we believe that the company is expected to earn ROE's of between 7.0% and 8.3%, which falls 3.2% to 4.5% below target ROE levels.

I. Return on Capital

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

We believe the Enterprises should operate with relatively stable and predictable earnings trajectories over time. While the utility-like nature of their single-family mortgage guarantee business produces very low credit losses in most market environments, the guarantees provided for the timely payment of principal and interest on mortgage-backed securities do present the risk of large losses during severe housing downturns. As a result, we believe there are at least four key components of the optimal return on capital for the enterprises;

- 1) The traditional risk-free rate on 10-year U.S. Treasuries, which currently approximates 4%.
- 2) The equity risk premium which is a function of both the variability of the enterprises' underlying business with the market, the required return on equity, and the types of equity capital employed (common equity vs. preferred).
- 3) A premium for projected insurance losses over time. This "insurance float" component would be expected to accumulate in most housing environments and support catastrophic insurance guarantees in the rare event of a severe downturn in home prices.
- 4) A premium for illiquidity and Conservatorship overhang. These are near-term considerations that should be eliminated if the enterprises were to be re-listed on a more liquid exchange like the NYSE. We would expect the Conservatorship overhang premium to persist in the minds of most investors for several years.

Overall, we believe the minimum long-term return on capital threshold for the enterprises should be between 11% and 12%. Based on a review of the cost of capital for peer companies across large commercial banks, large insurance institutions, and private mortgage insurers, we find that the market expects a return of between 9.1% and 9.8% (see Fig. 1), which includes only the first two factors above. We also add 2 percentage points to account for the expectation of future credit losses over time, which represents around \$3 billion in annual credit losses for Fannie Mae and \$2 billion in annual losses for Freddie Mac. Without explicitly including an allowance for these expected future losses on guaranteed loans during major recessions, we believe the enterprises would be under-earning relative to their long-term return targets. Together, this supports a return on capital threshold of between 11.1% and 11.8%. We specifically excluded the premium for illiquidity and Conservatorship overhang (factor 4), as we assume that these premia will be alleviated through a future status outside of Conservatorship, however these factors are real and bear consideration over the near-term.

Fig. 1: Comparable Company Analysis for Fannie Mae and Freddie Mac

Company	Ticker	Market Cap (\$B)	Total Assets (\$B)	Earnings per Share		Share Price	Earnings Yield %	Dividend Yield %	Beta	Cost of Equity Capital
				2023E	2024E					
Large Cap Banks and Asset Managers										
JP Morgan Chase	JPM	416.1	3,665.7	\$ 14.44	\$ 14.04	142.40	10.1%	2.8%	1.00	9.5%
Bank of America	BAC	228.6	3,051.4	3.37	3.31	28.68	11.8%	3.1%	1.07	9.9%
Wells Fargo	WFC	156.7	1,881.0	4.73	4.80	41.77	11.3%	2.9%	1.06	9.8%
Blackrock	BLK	103.3	117.6	34.86	40.00	685.27	5.1%	2.9%	1.29	11.1%
Citigroup	C	89.9	2,416.7	6.02	6.24	46.18	13.0%	4.4%	1.00	9.5%
US Bancorp	USB	49.2	674.8	4.43	4.62	32.08	13.8%	6.0%	0.99	9.4%
State Street	STT	24.2	301.5	7.74	8.51	72.50	10.7%	3.5%	1.28	11.0%
Median										
11.3%										
3.1%										
1.06										
9.8%										
Insurance										
Chubb Ltd.	CB	78.0	199.1	18.13	20.16	188.43	9.6%	1.8%	0.81	8.5%
Aon PLC	AON	69.2	32.7	14.33	16.09	338.91	4.2%	0.7%	0.90	9.0%
Travelers	TRV	39.4	115.7	14.50	16.99	170.63	8.5%	2.3%	0.77	8.2%
MetLife	MET	42.7	666.6	7.79	9.13	55.78	14.0%	3.7%	0.98	9.4%
American International Group	AIG	41.2	526.6	\$ 6.65	\$ 7.68	56.87	11.7%	2.5%	0.98	9.4%
Prudential	PRU	31.8	689.9	12.07	12.99	87.13	13.9%	5.7%	1.05	9.8%
Median										
10.7%										
2.4%										
0.94										
9.2%										
Private Mortgage Insurers										
Old Republic	ORI	7.3	25.2	2.42	2.53	24.97	9.7%	3.9%	0.88	8.9%
Essent Group	ESNT	5.0	5.7	6.14	6.59	46.43	13.2%	2.2%	0.97	9.3%
MGIC Investment Corp.	MTG	4.5	6.2	2.14	2.25	15.57	13.7%	2.6%	0.99	9.4%
Radian	RDN	3.9	7.1	3.31	3.15	25.10	13.2%	3.6%	0.76	8.2%
Mr. Cooper Group	COOP	3.4	12.8	5.36	7.02	50.59	10.6%		0.93	9.1%
Median										
13.2%										
3.1%										
0.93										
9.1%										
Government Sponsored Enterprises										
Fannie Mae	FNMA	2.5	4,305.3			0.43		0.0%	n/a	
Freddie Mac	FMCC	1.4	3,208.3			0.43		0.0%	n/a	

Data Source: Bloomberg.

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

There are no perfect peer companies for Fannie Mae and Freddie Mac, in our opinion. These are monoline insurers that provide catastrophic coverage across nearly 70% of home mortgages in the United States. Their insurance coverage is unique in that the loans they guarantee generally have at least 20% equity or private mortgage insurance against at least the first 20% decline in home value, with a large majority of their loans having significantly more equity than this. Due to the sheer size and scale of the enterprises' operations, we believe the best comparables are the large money-center commercial banks, including JP Morgan, Bank of America and Citigroup. We also include other companies such as State Street and Blackrock, as well as major insurance companies, like AIG, Aon, MetLife and Travelers. However, the deep coverage and monoline nature does create meaningful differences, and the enterprises should behave more like financial utilities with consistent and predictable earnings streams in all but the most severe housing downturns. Lastly, we include the private mortgage insurance businesses, including Essent, MGIC and Radian. These companies offer much more shallow insurance that takes losses often on the first 5-10% decline in home prices, so we do not view them as close analogues to the enterprises' business models apart from the housing end-market exposure.

4) *For which loan characteristics and products should the Enterprises accept a lower return?*

We do not see a strong reason to bifurcate target returns by product or specific underlying MBS characteristics. However, we do see a more nuanced approach to scoring risk-weights for the underlying mortgage portfolios as needed. The current risk weight floor applies a 20% risk weight to most of those loans in the guarantee pool, with some allowance for those with credit-risk transfer coverage under a new amendment. **We believe that a lower risk-weight floor is needed for loans with lower loan-to-value**

ratios (“LTV”), and that this should be adjusted based on the current LTV of the loans rather than the original LTV at the time the mortgage was originated.

For example, Fannie Mae reports in its latest 10-Q that 64% of its total single-family guaranty book of business has a current LTV of less than 60%. Another 16% of loans have current LTV’s between 60% and 70%. These are highly equitized loans that would not result in a loss of principal value even in a housing collapse that is similar to that experienced during the financial crisis of 2008. This 80% of Fannie Mae’s book representing low LTV loans compares with only 41% of the guarantee book which shows LTV’s below 70% based on their original LTV. Given the rapid rise in interest rates, we expect the majority of loans in Fannie Mae’s guarantee book to continue to season at very low prepayment speeds, resulting in progressively lower LTV’s and less risk of losses over time. These highly equitized loans should have a much lower risk floor, in our view. This lower risk-floor may also support lower guarantee fees, as there would be less required capital to earn a return against. We strongly encourage FHFA to consider linking future enterprise capital requirements to adjust for the level of these highly equitized and low-risk loan guarantees.

5) For which loan characteristics and products should the Enterprises target a higher return?

Like other industry participants, we share the view that guarantees for loans that are outside of the enterprises’ traditional mission and goals should come at a higher target return. This includes mortgages on 2nd homes or vacation properties, and loans on investment properties. The enterprises were originally chartered to ensure access to a liquid and stable 30-year mortgage product to support homeownership, particularly for 1st time homebuyers. By targeting a higher return on guarantees for 2nd homes and investor loans, it is more likely that this segment of the market would flow to other private market participants who can adequately score their risk. There are numerous behavioral characteristics that may cause these loans to become delinquent more readily than traditional owner-occupied homes. There may also be a case for targeting a higher return on adjustable-rate loans, given the probability that rate resets ultimately create a higher likelihood for mortgage delinquency, and therefore the expected credit loss component of the target return should be higher than for fixed-rate mortgages.

6) How should return on capital be calculated for the Enterprises?

Due to the size of the underlying mortgage guarantee portfolio which is carried on the balance sheets of the enterprises as debt and skews the debt/equity ratios, we believe the appropriate return on capital definition should consider return on equity. On a trailing basis, this would be calculated as Net Income divided by total risk-based capital requirements under the ERCF. We would consider net income as the level of earnings after any dividends to preferred shareholders.

Fannie Mae estimated its required CET1 capital on March 31, 2023, to be \$138B, and had total earnings over the preceding 12 months of \$12.3B. After deducting the expected \$1.3B in dividends due to outstanding Junior Preferred holders outside of Conservatorship, this translates to a return on common equity of 8.0%, or roughly 350 basis points below the 11-12% target return level.

II. Components of Guarantee Fees

10) *Should risk-based pricing be calibrated to the ERCF*

We believe that the most sustainable way for the enterprises to continue to support their affordable housing goals and provide liquidity to the secondary mortgage market is for them to operate in a future state outside of Conservatorship. It is important to link the level of risk-based pricing with the target ROE's discussed above and the level of capital required under the ERCF. Market participants will expect to earn a return equal to 11-12% on any new capital they invest in the enterprises, and while it is possible to achieve this through higher guarantee fees on most mortgage products, we believe this runs counter to purpose for which the enterprises were originally chartered. Instead, the ERCF should be calibrated to allow for reasonable guarantee fees that enable the enterprises to continue to support homeownership for 1st-time buyers and enhance equitable access to housing.

Currently we find that the enterprises would not be earning sufficient profits to meet realistic ROE targets. For example, Fannie Mae has earned an average of \$14 billion annually over the past five years, after adjusting for pro forma dividend payments to outstanding Junior preferred holders. We estimate that their earnings will be closer to \$13 billion annually over the 2023-24 period given expected credit losses in the multi-family portfolio, and to a lesser extent within the single-family portfolio. Given Fannie Mae's current leverage-based capital requirement of \$137 billion, and risk-based capital requirement of as much as \$184 billion, this translates to 9.5% return on equity under the minimum leverage requirement, or 7.1% return using the adjusted total capital requirement. These fall between 2% and 4.4% below the target ROE level of approximately 11.5%. To compensate for this shortfall, we estimate that G-fees would need to increase by as much as 30-40 basis points, bringing total G-fees to nearly 1.00%. This is not a desired outcome, either for the new homebuyers that the enterprises support, or for mortgage investors.

Fig. 2: Fannie Mae Earnings Power vs. Target ROE Based on ERCF Capital Levels

<i>(dollars in millions)</i>	2018	2019	2020	2021	2022	2023E	2024E	5-Yr Average	Target ROE	Returns Shortfall
Total Net Interest Income	20,951	20,962	24,866	29,587	29,423	28,400	28,600	25,158		
Pro Forma Net Income	14,696	12,897	10,542	20,913	11,660	13,800	13,000	14,142		
Minimum Leverage Req. Capital							114,000			
PLBA Buffer Capital							23,000			
Total Capital Requirement							137,000			
Implied ROE Based on Leverage Capital Requirement						10.1%	9.5%		11.5%	-2.0%
Risk-based Capital Req.										
Adj. Total Capital Minimum Requirement							105,000			
Applicable Buffers							79,000			
Total Adj. Total Capital Requirement							184,000			
Implied ROE Based on Risk-Based Capital Requirement						7.5%	7.1%		11.5%	-4.4%

One adjustment to this analysis is to consider the capital requirements assuming that the enterprises reach 50% of their applicable capital buffers. The ERCF specifies that there are some restrictions on the level of dividends and incentive bonuses that can be paid depending on what percentage of the capital buffers are reached. For example, if the capital buffer equals between 50% and 75% of the prescribed buffer amount, then the enterprise would be able to pay out a maximum of 60% of its earnings in dividends. We find that this level would give the enterprises adequate capacity to pay a sufficient return of capital to investors and

achieve reasonable dividend levels for common stockholders. Figure 3 outlines the ROE assumptions based on this 50% of capital buffer level for Fannie Mae, with the resulting returns shortfall declining to between 1.1% and 2.5% below the target ROE level. As demonstrated, the ERCF does provide some flexibility for management teams to calibrate returns based on what level of buffers they intend to achieve. However, without making changes to the risk-weight floors or capital buffer levels, it seems unlikely that the enterprises will achieve adequate ROE's based on the current structure of the ERCF.

Fig. 3: Fannie Mae Earnings Power vs. Target ROE at 50% of Capital Buffer Levels

<i>(dollars in millions)</i>	2018	2019	2020	2021	2022	2023E	2024E	5-Yr Average	Target ROE	Returns Shortfall
Total Net Interest Income	20,951	20,962	24,866	29,587	29,423	28,400	28,600	25,158		
Pro Forma Net Income	14,696	12,897	10,542	20,913	11,660	13,800	13,000	14,142		
Note: Maximum Dividend Payout (60% of P/F Net Income)						8,280	7,800	8,485		
Minimum Leverage Req. Capital							114,000			
50% of PLBA Buffer Capital							11,500			
Total Capital at 50% of Buffer							125,500			
Implied ROE Based on Leverage Capital at 50% of Buffer						11.0%	10.4%		11.5%	-1.1%
Risk-based Capital Req.										
Adj. Total Capital Minimum Requirement							105,000			
50% of Applicable Buffers							39,500			
Total Adj. Total Capital at 50% of Buffer							144,500			
Implied ROE Based on Risk-Based Capital at 50% of Buffer						9.6%	9.0%		11.5%	-2.5%

We appreciate the opportunity to engage with FHFA on this request for information and look forward to continuing to collaborate with the agency in the future as we work toward a more sustainable and robust housing finance system.

Sincerely,

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Appendix: Freddie Mac Earnings vs. Target ROE Analysis

For Freddie Mac, we find that the company has earned an average of \$8.1 billion annually over the past five years, after accounting for pro forma dividends to junior preferred shareholders. This translates to an ROE of between 7.0% and 8.3% based on the ERCF capital levels. These returns fall between 450bps below and 320bps below the target ROE level of 11.5%.

Fig. 4: Freddie Mac Earnings Power vs. Target ROE Based on ERCF Capital Levels

<i>(dollars in millions)</i>	2018	2019	2020	2021	2022	2023E	2024E	5-Yr Average	Target ROE	Returns Shortfall
Total Net Interest Income	12,757	13,887	14,323	22,992	19,423	19,400	18,700	16,676		
Pro Forma Net Income	8,374	6,353	6,465	11,248	8,466	8,400	8,600	8,182		
Minimum Leverage Req. Capital							93,000			
PLBA Buffer Capital							11,000			
Total Capital Requirement							104,000			
Implied ROE Based on Leverage Capital Requirement						8.1%	8.3%		11.5%	-3.2%
Risk-based Capital Req.							73,000			
Adj. Total Capital Minimum Requirement							50,000			
Applicable Buffers							123,000			
Total Adj. Total Capital Requirement							123,000			
Implied ROE Based on Risk-Based Capital Requirement						6.8%	7.0%		11.5%	-4.5%

If we repeat this analysis using 50% of the capital buffer levels, we find that Freddie Mac would earn a normalized ROE of 8.8% under both the leverage capital requirement and the risk-based capital requirement, or approximately 270bps below the target ROE level. In this example, Freddie Mac would be limited to a payout ratio of 60% of its pro forma net income, or approximately \$5.1B annually, which we feel is adequate to service obligations under both the junior preferred shares and pay a dividend on common shares.

Fig. 5: Freddie Mac Earnings Power vs. Target ROE at 50% of Capital Buffer Levels

<i>(dollars in millions)</i>	2018	2019	2020	2021	2022	2023E	2024E	5-Yr Average	Target ROE	Returns Shortfall
Total Net Interest Income	12,757	13,887	14,323	22,992	19,423	19,400	18,700	16,676		
Pro Forma Net Income	8,374	6,353	6,465	11,248	8,466	8,400	8,600	8,182		
Note: Maximum Dividend Payout (60% of P/F Net Income)						5,040	5,160	4,909		
Minimum Leverage Req. Capital							93,000			
50% of PLBA Buffer Capital							5,500			
Total Capital at 50% of Buffer							98,500			
Implied ROE Based on Leverage Capital at 50% of Buffer						8.5%	8.7%		11.5%	-2.8%
Risk-based Capital Req.							73,000			
Adj. Total Capital Minimum Requirement							25,000			
50% of Applicable Buffers							98,000			
Total Adj. Total Capital at 50% of Buffer							98,000			
Implied ROE Based on Risk-Based Capital at 50% of Buffer						8.6%	8.8%		11.5%	-2.7%