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SUMMARY

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Fannie Mae and Freddie Mac: Recent Administrative Developments

Congress chartered Fannie Mae and Freddie Mac, also known collectively as the Enterprises, to promote homeownership by providing liquidity to the secondary mortgage market. The Enterprises specifically facilitate financing for single-family residential mortgages and multifamily (apartment and condominium) construction. After purchasing pools of single-family 30-year fixed rate mortgages, the Enterprises retain the credit (default) risks from the whole mortgages and subsequently issue mortgage-backed securities (MBSs), which are bond-like securities. Investors who purchase MBSs are guaranteed a return on their initial principal and interest, but they assume prepayment risk, which is the risk that borrowers prepay their mortgages ahead of schedule. In contrast to the original mortgages, the MBSs are relatively more liquid, meaning they can be exchanged for cash more quickly with little change in their quoted prices. If institutional investors from around the globe are willing to hold liquid MBSs, then additional funds are channeled to the nation's mortgage market (particularly to support 30-year fixed rate mortgages). National mortgage rates tend to fall as the supply of funds in this market increases, making homeownership more affordable.

The Federal Housing Finance Agency (FHFA), an independent federal government agency created by the Housing Economic and Recovery Act of 2008 (HERA, P.L. 110-289), is the Enterprises' primary regulator. FHFA regulates the Enterprises for prudential safety and soundness and to ensure that they meet their affordable housing mission goals. In September 2008, the Enterprises experienced losses that exceeded their statutory minimum capital requirement levels as a result of above-normal mortgage defaults. The Enterprises also experienced losses following spikes in short-term borrowing rates that occurred while they were funding long-term assets held in their portfolios. The Enterprises were subsequently placed into conservatorship by FHFA, which currently has the powers of management, boards, and shareholders until the Enterprises' financial safety and soundness can be restored. In addition, the U.S. Treasury provides financial support through the senior preferred stock purchase agreements (PSPAs), which stipulate that the Enterprises must pay dividends to Treasury rather than private shareholders while they are under conservatorship. On September 30, 2019, Treasury announced stipulations to the PSPAs that would allow the Enterprises to retain their earnings for the purpose of accumulating capital reserves in preparation for eventual release from conservatorship.

Congressional interest in the Enterprises has continued since conservatorship. For one reason, the final costs to the U.S. Treasury (and, by proxy, to U.S. taxpayers) of providing the Enterprises financial support are unknown. In addition, the Enterprises' future viability could affect the availability of single-family 30-year fixed rate mortgage loan products. Although these mortgage products are arguably popular with borrowers, private lenders may be reluctant to retain in portfolio and fund relatively less liquid mortgages for several decades. Congressional interest has been reflected by various draft proposals, bills, and oversight hearings on housing finance reform. During the 118th Congress, for example, H.R. 5549, End of GSE Conservatorship Preparation Act of 2023, would require the Treasury Secretary to submit to Congress completed proposals for the termination of the Enterprises' conservatorships.

Meanwhile, FHFA's conservatorship goals have focused primarily on managing the Enterprises' liquidity, operational, and credit risks. FHFA has directed the Enterprises to standardize numerous processes to foster greater liquidity in the market for their MBSs. The Enterprises are also being required to share more of the credit risk linked to their single-family mortgage purchases with the private sector. Greater uniformity is expected to provide greater data integrity and reduce pricing irregularities, thereby fostering efficient operation of the primary and secondary mortgage markets.

On October 28, 2019, FHFA announced a strategic plan to prepare the Enterprises for their eventual exit from conservatorship. FHFA also adopted a final rule on December 17, 2020, that establishes a capital regulatory framework for the Enterprises to be in place once they exit conservatorship. The capitalization requirements are designed to increase the Enterprises' resiliency to another severe financial downturn. Furthermore, FHFA directs the Enterprises to pursue programs to meet affordable mission goals for low- and moderate-income households as mandated in their congressional charters. However, FHFA has also limited the Enterprises' activities in the multifamily (e.g., apartments) lending space that are not explicitly linked to their affordable mission goals. If the Enterprises were to exit conservatorship under current circumstances, their attempts to sustain profitability levels to meet shareholder equity requirements with limitations on lending activities could pose a future dilemma.

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Introduction

Congress chartered Fannie Mae and Freddie Mac, also known collectively as Enterprises,[1] to promote homeownership by providing liquidity to the secondary markets for single-family residential mortgages and multifamily (apartment and condominium) mortgages. Guaranteeing the credit (default) risk linked to single-family residential mortgages is their core business activity. Specifically, the Enterprises retain the credit risks from the mortgages they purchase from loan originators and subsequently issue bond-like instruments known as mortgage-backed securities (MBSs).[2] Investors who purchase the MBSs are guaranteed to get their initial principal investment returned, but they assume the risk of declining cash flows if borrowers repay their mortgages ahead of schedule, referred to as prepayment risk.[3] Hence, unlike mortgages with both prepayment and default risks, MBSs are more liquid (e.g., they can be traded or sold for cash more quickly) largely because only one type of lending risk is attached. Thus, MBSs can attract private sector funds that can be used to offer relatively less liquid mortgages—namely 30-year fixed-rate mortgages. National mortgage rates tend to fall as the supply of funds in the MBS market increases, making U.S. homeownership more affordable.

The Federal Housing Finance Agency (FHFA), an independent federal agency created by the Housing and Economic Recovery Act of 2008 (HERA, P.L. 110-289), is the Enterprises' primary regulator.[4] FHFA regulates the Enterprises for prudential safety and soundness and ensures they meet their affordable housing mission goals. In September 2008, the Enterprises experienced losses that exceeded their statutory minimum capital requirement levels due to the high rate of mortgage defaults. At the same time, the Enterprises also experienced losses following spikes in short-term borrowing rates that occurred while they were funding long-term assets held in their portfolios. The Enterprises subsequently agreed to be placed under conservatorship, meaning that FHFA has the powers of management, boards, and shareholders until restoration of the Enterprises' financial safety and soundness.[5] The terms in the senior preferred stock purchase agreements (PSPAs) between the Enterprises and the U.S. Treasury stipulate the conditions under which it will provide them with financial support while they are under conservatorship.[6] The PSPAs have been amended numerous times such that the initial requirement to pay cash

[1] Fannie Mae and Freddie Mac are often referred to as government-sponsored enterprises (GSEs). However, entities such as the Federal Home Loan Bank System and the Farm Credit System are also GSEs.

[2] Fannie Mae calls its securities MBSs, and Freddie Mac calls its securities participation certificates. Common industry practice is to refer to both Fannie's MBSs and Freddie's participation certificates collectively as MBSs.

[3] In addition to Fannie Mae and Freddie Mac, Congress created Ginnie Mae, a federal corporation that guarantees the timely repayment of principal and interest to investors in MBSs (created by Ginnie Mae–approved issuers) linked to mortgages in which the default risk has already been guaranteed by federal agencies, such as the Federal Housing Administration (FHA), the U.S. Department of Veterans Affairs (VA), and the U.S. Department of Agriculture (USDA). Hence, Ginnie Mae does not retain credit risk.

[4] Prior to FHFA's creation, the Office of Federal Housing Enterprise Oversight (OFHEO), which was an agency under the Department of Housing and Urban Development (HUD), was the safety and soundness regulator for Fannie Mae and Freddie Mac. OFHEO ensured that the Enterprises complied with their statutory capital requirements. The Enterprises' annual housing mission goals were set by HUD but not by OFHEO.

[5] See FHFA, "Conservatorship," https://www.fhfa.gov/Conservatorship.

[6] P.L. 110-289 gave the Treasury Secretary authority to lend or invest in the Enterprises. The Treasury's response to the Enterprises after they were undercapitalized was similar to its response after the banking system became undercapitalized, in which it purchased preferred shares from the banks via the Troubled Assets Relief Program. For information, see CRS Report R43413, *Costs of Government Interventions in Response to the Financial Crisis: A Retrospective*, by Baird Webel and Marc Labonte.

dividends to Treasury has been modified, currently allowing the Enterprises to accumulate the necessary capital reserves to exit conservatorship.[7]

Congressional interest in the Enterprises since they were placed in conservatorship has continued due to uncertainty in the housing, mortgage, and financial markets. For example, whether Treasury may have to provide additional financial support to the Enterprises is difficult to predict. In addition, reforming or replacing the Enterprises might affect the availability of single-family 30-year fixed-rate mortgage loan products, which are arguably more popular with borrowers (rather than private lenders that are more reluctant to retain the liquidity risks associated with these loans in their lending portfolios).[8] Congressional interest has been reflected by various draft proposals, bills, and oversight hearings on housing finance reform. For example, H.R. 5549, the End of GSE Conservatorship Preparation Act of 2023, which was introduced during the 118th Congress, would require the Treasury Secretary to submit to Congress completed proposals for the termination of the Enterprises' conservatorships.[9]

This report begins with an overview of Fannie Mae's and Freddie Mac's secondary mortgage market activities. It then discusses FHFA's administrative directives pertaining to the management of the Enterprises' credit and liquidity risks. The directives specifically focus on reducing potential risks that could be borne by U.S. taxpayers, standardizing numerous processes to foster greater liquidity in the market for their MBSs, and increasing their capital reserves to prepare for their exit from conservatorship. Finally, this report discusses how the Enterprises may operate following their conservatorships.

Enterprises' Secondary Mortgage Market Activities

By law, the Enterprises cannot originate mortgages directly to borrowers, who obtain their mortgages from loan originators in the primary market. Instead, the Enterprises operate in the secondary mortgage market, interacting with loan originators (which sell mortgages to the Enterprises) and investors (which purchase the Enterprises' debt and MBS issuances). The Enterprises interact with MBS investors in both the primary and secondary MBS markets. The Enterprises' securitization activities, which facilitate the acquisition of funds from the ultimate lenders to mortgage borrowers, are discussed in the sections below.

Transfer of Mortgage Prepayment Risk, Retention of Credit Risk

In the secondary market, the Enterprises purchase homeowners' *conforming mortgages* from loan originators. Conforming mortgages are single-family mortgages that meet certain eligibility criteria set by the Enterprises based on size and creditworthiness.[10] These mortgages must meet the Enterprises' underwriting standards and cannot exceed the *conforming loan limit*, which is adjusted each year to reflect the changes in the national average home prices.[11] The Enterprises

[7] For more historical information about the chartering of Fannie Mae and Freddie Mac, see "Why Were Fannie Mae and Freddie Mac Created?" in CRS Report R44525, *Fannie Mae and Freddie Mac in Conservatorship: Frequently Asked Questions*, by Darryl E. Getter.

[8] See Richard K. Green and Susan M. Wachter, "The American Mortgage in Historical and International Context," *Journal of Economic Perspectives*, vol. 19, no. 4 (Fall 2005), pp. 93-114.

[9] H.R. 5549 was introduced in the House and referred to the House Committee on Financial Services.

[10] These mortgages tend to have fixed interest rates with a 30-year maturity.

[11] FHFA establishes the annual conforming loan limits for one-to-four-unit properties. For most areas in which the median local house value exceeds the national average house value by 115%, the conforming loan limit is set at 115% of the median home value. FHFA establishes separate conforming loan limit for Alaska, Hawaii, Guam, and the U.S. Virgin Islands.

use two methods to acquire conforming mortgages. An Enterprise may pay cash (directly from its cash window) to a loan originator for delivery of a small number of mortgages. Alternatively, an Enterprise may enter into a *swap agreement* with a loan originator to purchase a large number (or pool) of mortgages. In exchange for a pool, the purchasing Enterprise delivers one (or more) MBS that is linked to the *MBS trust* holding the mortgages. An MBS trust is a legal entity established to hold pools of conforming mortgage loans.[12]

As borrowers repay their mortgages, the streams of principal and interest are collected by loan servicers and forwarded to investors in MBSs issued by the Enterprises. An investor that purchases an MBS receives a *coupon*, which is the yield composed of the principal and interest repayments from borrowers whose mortgages are held in MBS trusts.[13] However, various fees are subtracted before the coupons are paid to investors.[14] For example, a designated mortgage servicer retains a fee to collect borrowers' regular payments, resolves borrower delinquency and default problems, and disburses payments to the Enterprises (which subsequently disburse payments to MBS investors). Other fees related to the home purchase (e.g., settlement costs) that borrowers may have chosen not to pay upfront may also be subtracted. Simply put, the MBS coupon is the rate of return net of fees that an investor receives for purchasing or investing in an MBS.

The Enterprises' profits are related to *lending spreads*—the difference between lending at higher rates and borrowing at successive sequences of shorter rates—created to finance assets retained in their lending portfolios (on-balance sheet) and the conforming mortgages held in the MBS trusts (off-balance sheet). For the on-balance-sheet assets retained in their portfolios, the Enterprises issue to investors debt securities—referred to as unsecured *debentures—*with shorter maturities relative to the longer-term assets. By borrowing via successive sequences of lower-rate debentures, the Enterprises create portfolio lending spreads. For the off-balance-sheet MBS trusts, the Enterprises' profits are subtracted from lending spreads, which are created as the difference between the longer-term mortgage rates paid by borrowers and the MBS coupons paid to MBS investors.[15] In other words, the *guarantee fee (g-fee)*—the residual following the subtraction of the shorter-term MBS coupons as well as the loan servicing and other ancillary fees from the longer-term borrowers' mortgage coupons—is the compensation the Enterprises receive for guaranteeing to investors timely payment of the MBS coupons and for retaining the default risks of the mortgages held in the MBS trusts.[16]

[12] The MBS trusts are bankruptcy-remote or special-purpose entities, meaning that the parent company (e.g., one of the Enterprises) isolates and holds these assets in the trust rather than on its own balance sheets. If, for example, a parent company goes bankrupt, then the stipulated activities of a special-purpose entity are not disrupted given that the trust assets are legally not owned by the parent company. In this case, the assets (mortgages) held in the MBS trusts are funded by MBS issuances.

[13] For detailed descriptions of loan securitizations and MBS trust guarantees, see Fannie Mae, *Basics of Fannie Mae Single-Family MBS*, January 2019, http://www.fanniemae.com/resources/file/mbs/pdf/basics-sf-mbs.pdf.

[14] For example, if the average interest rate of the underlying pool of mortgages is 4% or 400 basis points, an Enterprise may retain an average of 56 basis points and pass the remaining 344 basis points to the MBS holders after subtracting additional basis points for mortgage servicers (typically 25 basis points) and paying for other costs to originate the loan. See FHFA, "FHFA Issues 2017 Report to Congress on Guarantee Fees," press release, December 10, 2018, https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Issues-2017-Report-to-Congress-on-Guarantee-Fees.aspx.

[15] For more information on the pricing of single-family mortgages—specifically how mortgage coupons paid by borrowers are calculated—see CRS Report R46980, *Single-Family Mortgage Pricing and Primary Market Policy Issues*, by Darryl E. Getter.

[16] The Enterprises, therefore, are monoline insurance companies. See FHFA, "Enterprise Capital Requirements," 83 *Federal Register* 137, July 17, 2018. Bond insurers guarantee (for a fee) that the interest payment streams generated from a bond (or loan) will be made on time and that, if a default occurs, the initial principal investment will be returned (continued...)

The Enterprises' securitization process, therefore, entails detaching two specific mortgage risks—the risk of repaying early and the risk of repaying late (or not at all)—into separate components. *Prepayment risk*, the risk that borrowers will repay their mortgages ahead of schedule, results in lower revenues. For example, if mortgage rates decline, some borrowers may repay their existing mortgages early by refinancing (replacing) them into new mortgages with lower rates. Borrowers also prepay their mortgages when they move. In this case, the Enterprises pass on the repayment of principal but reduce the investors' MBS coupons by the amount of interest forgone.[17] The Enterprises retain the *credit (default) risk*, the risk that the mortgage obligation will not be repaid, and charges g-fees. Should a delinquency or default occur, the applicable Enterprise purchases the defaulted mortgage (for the amount of the remaining balance owed) out of the MBS trust.[18] After a borrower defaults, the purchase effectively reimburses the associated MBS trust and, therefore, prevents MBS investors from losing their initial principal investments. The MBS coupon is subsequently adjusted for the reduced stream of interest payments, thus making it appear to investors that mortgage obligations have been repaid ahead of schedule (rather than defaulted). MBSs, therefore, are conceptually equivalent to derivative products that contain one, rather than both, of the financial risks attached to the original mortgages that the Enterprise purchased.[19]

MBSs Markets and Liquidity Premium Management

In the *secondary mortgage market*, the Enterprises acquire existing mortgages, which are used to subsequently create new MBSs for issue in the *primary MBS market*. In other words, the Enterprises deliver new MBSs to investors in the primary MBS market, otherwise referred to as the *to-be-announced (TBA)* market, via swap agreements.[20] The TBA market is a *forward* market, meaning that a swap agreement to simultaneously sell a pool of mortgages to an Enterprise and purchase MBSs linked to the underlying pool occurs in advance of the MBS securities' delivery and settlement date. Interest rates—and, therefore, bid-ask spread movements—may occur over the gap period between entering and settlement of a swap agreement.[21] Investors wanting to hedge against adverse bid-ask movements prior to delivery of their MBS purchases may require higher compensation (e.g., hedging fees, premiums) to cover the possibility of adverse price movements that could cause the securities to become less liquid prior to the settlement date. These costs may be passed to homeowners, particularly those willing to lock in their mortgage rates over the period of time until their closing settlement dates.

Following TBA market issuance, the Enterprises' MBSs—just like other types of bonds and securities—can subsequently trade directly (via broker-dealers) between two parties in what are

to the bondholder. Likewise, the Enterprises facilitate the equivalent transaction on a larger scale, referring to the process as *securitization*.

[17] The process when borrowers prepay mortgages that underlie Ginnie Mae MBSs is similar.

[18] The Enterprises define default as 120 days late.

[19] In finance, a *derivative* is a financial instrument with value linked to at least one but not all of the risks contained in a reference bond. In this case, the MBS derivative instruments have the prepayment risk but not the default risk that is contained in the underlying reference mortgage.

[20] Ginnie Mae facilitates MBSs that it issues in the TBA market. Ginnie Mae transfers prepayment risk in a similar manner as the Enterprises, but it does not retain default risk. The default risk is retained by the federal agencies—FHA, VA, and USDA—that provide mortgage insurance.

[21] For example, following a decline in mortgage rates during the COVID-19 pandemic, mortgage pools scheduled for delivery experienced an increase in prepayment risk, thereby reducing their liquidity. The liquidity loss was reflected by a widening gap between the present value of the mortgage pool and the future MBS prices at settlement. See Jiakai Chen et al., *Dealers and the Dealer of Last Resort: Evidence from the MBS Markets in the COVID-19 Crisis*, Federal Reserve Bank of New York, July 2020, https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr933.pdf.

referred to as *over-the-counter* (OTC) market or secondary securities market transactions.[22] Secondary bond markets are typically *thin*, meaning that bonds generally trade infrequently, and the trade sizes vary, which may cause valuation (pricing) challenges—sometimes leading investors and market-makers to perceive that the bonds may be *illiquid*.[23] Illiquid securities cannot easily be converted into cash or traded within a reasonable time—that is, without affecting their quoted prices. Investors arguably might offer (bid) "too much" to buy or sell (ask) for a price "too low" when trading illiquid securities. Consequently, investors require additional compensation, referred to as a *liquidity premium*, to buy or sell illiquid securities.[24] Widening bid-ask spreads might signal the emergence of a liquidity premium being incorporated in securities prices.[25] Likewise, liquidity premiums can also emerge when MBSs trade in the OTC (i.e., secondary) MBS market. Persistent liquidity premiums may result in higher mortgage rates for future homeowners if investors demand higher yields (i.e., higher coupons) to offset the risk that future sales of their MBSs would occur at prices considered "too low" due to market illiquidity.[26]

Prior to conservatorship, the Enterprises could actively trade their own MBSs in the secondary OTC market to facilitate liquidity.[27] By conducting OTC market trades when the bid-ask spreads for MBS widened, the Enterprises could abate rising liquidity premiums and reduce mortgage costs for borrowers.[28] Hence, high-volume trading by the Enterprises facilitated narrower bid-ask MBS spreads and hedging fees in both the OTC and TBA markets, respectively.[29] (The Enterprises held their own MBSs to show incentive alignment with investors, meaning the Enterprises were willing to hold the same risks that they were selling.[30]) Thus, despite intermittent episodes of budding liquidity premiums, MBSs issued by the Enterprises were considered to be almost as liquid as U.S. Treasury bonds.[31]

The current $250 billion cap on the Enterprises' asset portfolios (resulting from the PSPAs) may limit their ability to buy and sell MBSs at the volumes necessary to influence market pricing.

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[22] See Financial Industry Regulatory Authority, "Unraveling the Mystery of Over-the-Counter Trading," *The Alert Investor*, January 4, 2016, https://www.finra.org/investors/unraveling-mystery-over-counter-trading.

[23] The increase in electronic trading has increased price transparency in many OTC markets. See Randall Dodd, "Markets: Exchange or Over-the-Counter," International Monetary Fund, https://www.imf.org/external/pubs/ft/fandd/basics/markets.htm.

[24] See Douglas J. Elliott, "Market Liquidity: A Primer," Brookings Institution, June 2015, https://www.brookings.edu/wp-content/uploads/2016/07/Market-Liquidity.pdf.

[25] See Rich Podjasek et al., "Has MBS Market Liquidity Deteriorated?," Federal Reserve Bank of New York, February 8, 2016, https://libertystreeteconomics.newyorkfed.org/2016/02/has-mbs-market-liquidity-deteriorated.html.

[26] Whether investors found MBSs attractive due to their lack of credit risk or their OTC market liquidity is subject to debate. See James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, Federal Reserve Bank of New York, May 2013, http://www.newyorkfed.org/research/epr/2013/1212vick.pdf.

[27] See Scott Richardson and Diogo Palhares, "(Il)liquidity Premium in Credit Markets: A Myth?," *Journal of Fixed Income*, vol. 28, no. 3 (Winter 2019), pp. 3-21.

[28] See Congressional Budget Office, *Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market*, December 2010, https://www.cbo.gov/sites/default/files/111th-congress-2009-2010/reports/12-23-fanniefreddie.pdf.

[29] See Karan Kaul, "The Past, Present and Future of Agency MBS Liquidity," prepared for Ginnie Mae by State Street Global Advisors and the Urban Institute's Housing Finance Policy Center, October 2016, https://www.ginniemae.gov/newsroom/publications/Documents/agency_mbs_liquidity.pdf.

[30] See Robert Van Order, "Government-Sponsored Enterprises and Resource Allocation: Some Implications for Urban Economics," in *Brookings-Wharton Papers on Urban Affairs*, ed. Gary Burtless and Janet Rothenberg Pack (Washington, DC: Brookings Institution, 2007), pp. 151-203.

[31] See Karan Kaul and Laurie Goodman, "Declining Agency MBS Liquidity Is Not All About Financial Regulation," Urban Institute, November 2015, https://www.urban.org/sites/default/files/publication/72621/2000503-Declining-Agency-MBS-Liquidity-Is-Not-All-about-Financial-Regulation.pdf.

Although the Federal Reserve has purchased large amounts of the Enterprises' MBS while carrying out its lender-of-last-resort responsibilities, it has largely retained them in its asset portfolio rather than actively trading them.[32] Hence, less active trading of MBSs by the Enterprises and more holding (rather than actively trading) of MBSs by the Federal Reserve might explain declines in market liquidity observed prior to the COVID-19 pandemic.[33]

FHFA's Conservatorship Priorities

Since conservatorship, FHFA has released various versions of strategic plans and performance goals.[34] FHFA has focused primarily on (1) reducing the credit risks (which pose a direct risk to U.S. taxpayers) retained by the Enterprises and (2) increasing the liquidity of their MBS issuances. The directives that focus on those risks are highlighted in this section.

Directives to Reduce the Enterprises' Credit Risks

The PSPAs required the Enterprises to reduce taxpayers' credit risk. Various programs to facilitate the Enterprises' credit risk management are discussed in this section.

Loan-to-Value Ratios and Mortgage Reinsurance Transactions

By statute, additional credit risk reduction measures are required if the Enterprises purchase mortgages with loan-to-value ratios (LTVs) above 80%, meaning that the mortgage balance exceeds 80% of the residential property value.[35] If a borrower defaults, the Enterprise generally recovers losses by foreclosing (repossessing) and then liquidating (selling) the property. If a repossessed property sells for at least 80% of its original value, then the 80% LTV requirement increases the likelihood that an Enterprise would recover enough proceeds to cover the remaining mortgage balance.[36] Mortgage insurance is used when borrowers lack the funds to make down payments that would bring their LTVs to 80% or lower.[37] Borrowers can purchase private mortgage insurance, which would assume the first 20% (or more in some cases) of losses associated with a mortgage default.[38]

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[32] See Board of Governors of the Federal Reserve System, "Authority to Lend to Fannie Mae and Freddie Mac," press release, July 13, 2008, http://www.federalreserve.gov/newsevents/press/other/20080713a.htm.

[33] Kaul and Goodman, "Declining Agency MBS Liquidity."

[34] FHFA issues annual *scorecards*, which communicate the annual priorities and expectations that it sets for the Enterprises with respect to both of their single-family and multifamily mortgage businesses while under conservatorship. See FHFA, "Conservatorship."

[35] 12 U.S.C. §1717.

[36] The property value would have been determined by an appraisal when the mortgage was originated. Property values, however, are not constant and might increase or decrease by the time a borrower officially defaults. The Enterprises' definition of *default* is 120 days delinquent. A loss mitigation or workout option may be able to resolve a default if the property's value exceeds the outstanding mortgage balance. If the property value falls below the outstanding mortgage balance, the likelihood that a loss mitigation option will succeed diminishes.

[37] Certain borrowers may also qualify to obtain federal mortgage insurance from the FHA, VA, or USDA. Because federally insured mortgages are backed by the full faith and credit of the U.S. government, the Enterprises face no counterparty credit risk when borrowers choose this option. Another option for borrowers may be to obtain a junior (second) loan for some or all of the 20% down payment requirement. After the property is liquidated in a foreclosure sale, the recovered proceeds would be distributed first to the Enterprises. The junior lender would receive any proceeds left over to cover the unpaid portion of the junior loan. Given that foreclosure costs can be substantial, the mortgage insurer or second lender faces a greater possibility of little or no recoupment of loan proceeds.

[38] According to FHFA, mortgage insurers represent the largest counterparty exposure for the Enterprises. See FHFA, (continued...)

The Enterprises introduced additional methods to facilitate the transfer of credit risk stemming from low-down-payment borrowers referred to as *mortgage reinsurance transactions*. In their pilot programs, the Enterprises initially paid the mortgage insurance premiums upfront and were reimbursed later by borrowers via interest rate adjustments on their loans, thus streamlining the origination process for some borrowers in need of private mortgage insurance. Fannie Mae's pilot program, the Enterprise-Paid Mortgage Insurance Option, and Freddie Mac's pilot program, Integrated Mortgage Insurance, ended in June 2021.[39]

Guarantee Fees and Loan Level Price Adjustments

As previously discussed, the Enterprises' revenues are generated by g-fees, which can be set to target returns by lines of business, cover potential credit losses, and mitigate losses to taxpayers.[40] G-fees are established at the same time when the interest rates for single-family mortgages are determined.[41] Specifically, a loan originator typically receives a *rate sheet* from Fannie Mae or Freddie Mac with a designated minimum base mortgage rate and the various risk adjustments, referred to as the loan-level price adjustments (LLPAs), which are subsequently added to the base rate. After gathering a mortgage applicant's credit score and down payment amount, the loan originator goes to the LLPA matrixes to locate the corresponding fees that are added to the base rate. Borrowers with low default risk characteristics generally pay lower LLPAs compared to those with high default risk characteristics. The higher LLPAs are structured to compensate for elevated levels of default risk attributed to high-risk borrowers. For loans such as a cash-out refinances or investment properties, which may be associated with higher default risk or are not directly related to the policy goal of increasing homeownership, respectively, additional LLPA fees may be attached.

On January 19, 2023, FHFA directed the Enterprises to alter their g-fee schedules as part of the strategic plan to improve their financial conditions.[42] Under the new LLPA fee structure, most prospective borrowers pay higher LLPAs. All borrowers with low default risk characteristics will continue to pay lower LLPAs compared to those with high default risk characteristics.[43] The increase in g-fee revenues may expedite the Enterprises' ability to accumulate more retained earnings necessary to exit conservatorship.

The Enterprises' g-fees can be separated into two components. First, the upfront g-fee is determined by the borrower's risk characteristics (e.g., credit score, LTV). Second, the ongoing g-fee, which is collected each month over the life of the loan, is determined by the product type (e.g., fixed rate, adjustable). In December 2011, Congress directed the Enterprises to increase their ongoing g-fees for all loans by 10 basis points (or 0.1% given that a single basis point is

Office of the Inspector General, *Enterprise Counterparties: Mortgage Insurers*, February 16, 2018, https://www.fhfaoig.gov/Content/Files/WPR-2018-002.pdf.

[39] See FHFA, Office of the Inspector General, *Enterprise Counterparties: Reinsurers*, September 27, 2021, https://www.fhfaoig.gov/sites/default/files/WPR-2021-007.pdf.

[40] See Edward Golding et al., "How to Think About Fannie Mae and Freddie Mac's Pricing," Urban Institute, August 2023, https://www.urban.org/research/publication/how-think-about-fannie-mae-and-freddie-macs-pricing.

[41] See CRS Report R46980, *Single-Family Mortgage Pricing and Primary Market Policy Issues*, by Darryl E. Getter.

[42] FHFA, "FHFA Announces Updates to the Enterprises' Single-Family Pricing Framework," press release, January 19, 2023, https://www.fhfa.gov/news/news-release/fhfa-announces-updates-to-the-enterprises-single-family-pricing-framework.

[43] A category of prospective high-risk borrowers will pay slightly lower LLPAs compared to the previous LLPA fee structure. Although slightly lower premiums for this group may potentially may increase affordability and promote more stable payment behavior, the anticipated revenues generated may not be large given that fewer high-risk borrowers can qualify for as many mortgages or for those as large as those obtained by low-risk borrowers.

equal to 1/100 of a percent—100 basis points is 1%), which took effect on December 1, 2012, for loans exchanged for MBSs.[44] In November 2021, Congress extended the 10-basis-point ongoing g-fee until 2032.[45] These risk characteristics and other requirements are factors taken into account when charging g-fees.[46]

Credit Risk Transfer Programs

In July 2013, the Enterprises initiated new credit risk transfer (CRT) programs to share a portion of the credit risk linked to their guaranteed single-family mortgages with the private sector.[47] Both Enterprises now offer CRT financial instruments that are linked only to the *credit risk* of the single-family mortgages held in the MBS trusts.[48] Investors preferring exposure only to mortgage *prepayment risk* may continue to purchase MBSs, but the private sector may now purchase CRT issuances to earn revenue in exchange for assuming exposure to the credit risk.

The Enterprises transfer to investors the credit risk linked to mortgages with LTVs *greater* than 60% (or borrowers with 40% or less in accumulated home equity, making them more vulnerable to the possibility of owing more than the initial value of their homes if housing market prices were to fall).[49] After defaults occur, the Enterprises write down the coupons paid to CRT investors (similar to adjusting the MBS coupons downward after prepayments occur).[50] The Enterprises retain the credit risk for mortgages with *lower* LTVs (or borrowers with 41% or more in accumulated home equity such that their outstanding balances are significantly below the value of their residential properties), which are less likely to default.[51]

[44] Temporary Payroll Tax Cut Continuation Act of 2011 (P.L. 112-78).

[45] The Infrastructure Investment and Jobs Act (P.L. 117-58).

[46] Section 1601 of HERA requires FHFA to conduct an ongoing study of the guarantee fees charged by the Enterprises. For more information and recent reports, see FHFA, "Fannie Mae and Freddie Mac Guarantee Fees," https://www.fhfa.gov/policy/guarantee-fees.

[47] Prior to conservatorship, the Enterprises had existing programs that transferred the credit risk linked to their multifamily programs. For more information, see the section of this report entitled "The Enterprises' Multifamily Business Models."

[48] See FHFA, *Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions*, August 2015, https://www.fhfa.gov/sites/default/files/2023-03/CRT-Overview-8-21-2015.pdf.

[49] See FHFA, *Performance and Accountability Report: FY2018*, https://www.fhfa.gov/sites/default/files/documents/FHFA-2018-PAR.pdf.

[50] Transferring credit risk via CRT instruments reduces counterparty risk—that is, the risk that the insurer fails to reimburse the Enterprise after a default.

[51] The Enterprises may also transfer the credit risk of mortgages retained in their portfolios (typically because they lack the standardized features that would make them eligible for placement into an MBS trust for securitization).

CAS and STACR Risk-Tiering Structures

The Fannie Mae's CRT instruments are known as Connecticut Avenue Securities (CAS); Freddie Mac's CRT instruments are known as Structural Agency Credit Risk (STACR). The CAS and STACR issuances are structured in a tiered system consisting of tranches: a first-loss tranche, two mezzanine tranches, and a senior tranche.

- The first-loss tranche is used to transfer *expected* credit loss risk. FHFA defines *expected* credit losses as those likely to occur during periods of stable housing market conditions when some borrowers fail to repay their mortgages, perhaps due to unforeseen life circumstances (e.g., job loss, disability, divorce). The first-loss tranche absorbs the initial 5% of credit losses linked to mortgages held in MBS trusts. The Enterprises retain 5% of the first-loss tranche and issues the remaining 95% of CRTs to first-loss tranche investors. The Enterprises retain 5% of the issuances associated with the first-loss (and mezzanine tranches), signaling to investors their willingness to hold the same risks that they are willing to issue (as they do when holding their own MBSs), which is also consistent with risk-retention requirements for securitizations.[52]
- The mezzanine tranches are used to transfer *unexpected* credit loss risk. FHFA defines *unexpected* credit losses as those likely to result from macroeconomic events, such as a recession. The mezzanine tranches collectively absorb mortgage credit risk after 5% and up to 45% of total credit losses linked to mortgages held in MBS trusts. For the mezzanine tranches, the credit risk is distributed as follows:[53] The Enterprises retain 5% of all mezzanine tranche risk. The private sector retains 60% of mezzanine risk via purchases of the Enterprises' CRT issuances. For the remaining 35% of mezzanine risk, the Enterprises rely upon another set of CRT risk-sharing programs in which they directly obtain insurance or reinsurance.[54] Just as the Enterprises charge g-fees, they pay credit insurance premiums to insurance and reinsurance firms to assume a predetermined dollar amount of the credit risk.[55] Fannie Mae's program is known as Credit Insurance Risk Transfer; Freddie Mac's corresponding program is known as Agency Credit Insurance Structure. Participating institutions, primarily insurers and reinsurers, may use proceeds from these programs to diversify their portfolios if they have assets that are not highly correlated to U.S. residential mortgage credit risk.
- The Enterprises retain all of the senior-tranche risk, which contains *catastrophic* credit loss risk. Catastrophic credit losses are those linked to catastrophic events with historically low probabilities of occurrence. The senior tranche absorbs credit losses after the mezzanine and first-loss tranches have absorbed the initial 45% of the mortgage credit losses linked to mortgages held in MBS trusts.[56] For this reason, the catastrophic credit loss risk is more economical for the Enterprises to retain rather than attempt to issue CRTs with sufficiently attractive compensation to encourage retention by private investors.[57]

Although the CRTs may reduce the Enterprises' default risk exposure, the Congressional Budget Office reported that these transactions may not necessarily reduce taxpayers' costs.[58] When transferring default risk to the private sector, the Enterprises simultaneously transfer a portion of the g-fee income to the CRT holders. In other words, the trade-off between risk and reward applies in this context such that credit risk reduction for the Enterprises also translates into a portion of g-fee revenue forgone.

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[52] For more information, see Board of Governors of the Federal Reserve System, "Six Federal Agencies Jointly Approve Final Risk Retention Rule," press release, October 22, 2014, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20141022a.htm.

[53] See FHFA, *Performance and Accountability Report: FY2018*.

[54] See David Finkelstein, Andreas Strzodka, and James Vickery, *Credit Risk Transfer and De Facto GSE Reform*, Federal Reserve Bank of New York, February 2018, https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr838.pdf; and FHFA, *Performance and Accountability Report: FY2018*.

[55] The term *reinsurance* may be used because the credit risk is insured twice: once by the Enterprises and a second time by another insurance company.

[56] FHFA acknowledges that a bright line distinction between unexpected and catastrophic loss risk has yet to be defined. The distinction between risk types, however, may not be pertinent, because credit risk is measured in basis points, and the total amounts transferred to the private sector occur after certain basis point thresholds.

[57] See Joshua D. Coval, Jakub W. Jurek, and Erik Stafford, "Economic Catastrophic Bonds," *American Economic Review*, vol. 99, no. 3 (June 2009), pp. 628-666.

[58] See Congressional Budget Office, *Transitioning to Alternative Structures for Housing Finance: An Update*, August 2018, p. 9, https://www.cbo.gov/system/files/2018-08/54218-GSEupdate.pdf.

Standardization Initiatives to Foster MBS Liquidity

FHFA introduced initiatives to standardize many aspects of the Enterprises' operations, which include their mortgage data collection processes, securitization processes, mortgage servicing guidelines (e.g., resolving delinquencies), and MBS issuances. Greater uniformity is expected to provide greater data integrity for appraisers, servicers, and secondary-market investors. Such standardization may increase transparency, reduce the length of the single-family mortgage origination and securitization processes, and ultimately increase the uniform pricing and liquidity of the Enterprises' MBS and CRT issuances.[59] These initiatives are discussed in this section.

Uniform Mortgage Data Program

FHFA's uniform mortgage data program initiative requires the Enterprises to support standardization of the single-family primary mortgage market data information used by the industry.[60] Data on loan applications, property appraisals, loan closings, and disclosures are the focus of the standardization efforts. Mortgage originators must prepare more standardized and streamlined mortgage loan packages that could be sent and used by either Enterprise. Greater standardizing of mortgage loan packages will expedite the identification of irregularities, which is likely to increase efficiencies in the following areas:

- Standardization may enhance the Enterprises' automated delegated underwriting processes, which rely on the sellers (loan originators) of conventional single-family mortgages to provide information about the mortgage and underwriting standards.[61] Standardization may quickly underscore abnormal credit risks and fraudulent information about the borrower, underlying property, or other involved stakeholders (e.g., property seller, title agent, servicer) that could trigger financial losses. Rather than independently verify the information, the Enterprises review samples of their loans to see what percentage meets the contractual standards. Furthermore, because the Enterprises purchase most loans using *representations and warranties*—that is, contracts that require loan originators to repurchase mortgages that fail to meet contractual standards—standardization may reduce *put-back risk*, the risk that originators must repurchase unacceptable mortgages.[62]

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[59] For more information on the mortgage servicing and loss mitigation initiatives, see FHFA, "Mortgage Servicing," https://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Mortgage-Servicing.aspx; and Karan Kaul et al., *The Case for Uniform Mortgage Servicing Data Standards*, Urban Institute, November 2018, https://www.urban.org/sites/default/files/publication/99317/uniform_mortgage_servicing_data_standards_0.pdf. The standardization of servicing may enhance the attractiveness of CRT investments by clarifying the procedures for handling nonperforming mortgages, thus clarifying how losses will be distributed among the various tranche classes. For more information, see Basel Committee on Banking Supervision: The Joint Forum, *Report on Asset Securitisation Incentives*, July 2011, https://www.bis.org/publ/joint26.pdf; and Patricia A. McCoy, "Barriers to Federal Home Mortgage Modification Efforts During the Financial Crisis," Harvard University Joint Center for Housing Studies, August 2010, https://www.jchs.harvard.edu/sites/default/files/mf10-6.pdf.

[60] FHFA, "Uniform Mortgage Data Program," https://singlefamily.fanniemae.com/delivering/uniform-mortgage-data-program.

[61] See Freddie Mac, Form 10-K for the fiscal year ended December 31, 2018, p. 186, https://www.fhfa.gov/sites/default/files/documents/FHFA-2018-PAR.pdf; and Fannie Mae, Form 10-K for the fiscal year ended December 31, 2018, p. 33, https://www.fanniemae.com/sites/g/files/koqyhd191/files/migrated-files/resources/file/ir/pdf/quarterly-annual-results/2018/q42018.pdf.

[62] See FHFA, "FHFA, Fannie Mae and Freddie Mac Launch New Representation and Warranty Framework," press release, September 11, 2012, https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Fannie-Mae-and-Freddie-Mac-Launch-New-Representation-and-Warranty-Framework.aspx; and Laurie Goodman, Ellen Seidman, and Jun Zhu, (continued...)

- Standardization may facilitate oversight related to fair lending, fair housing, and unfair or deceptive act or practices. For example, on August 10, 2022, FHFA announced that the Enterprises would require mortgage servicers to obtain and maintain fair mortgage data beginning on March 1, 2023.[63] The fair lending data would include information such as the accept rate, representing the proportion of applicants approved by the Enterprises' underwriting systems.[64] Although the data alone cannot prove or disprove unlawful discrimination, they can facilitate monitoring trends and irregularities that may be useful in terms of identifying fair lending risk and monitoring compliance.
- The Enterprises have adopted standardized credit scores, which may assist with further minimizing price differentials between the Enterprises' MBS issuances (a topic discussed in the section below entitled "Uniform MBS Single Security Initiative"). Specifically, Section 310 of P.L. 115-174, enacted in 2018, required FHFA to establish standards and criteria for the Enterprises' credit score model validation and approval processes, which lead to the approval and implementation of newer credit score models.[65]

The focus on standardization and automation, therefore, can increase various efficiencies not only for the Enterprises but also for any private sector guarantors or other stakeholders entering the mortgage or broader financial industry.[66]

Common Securitization Platform

In 2012, FHFA determined that both technology platforms the Enterprises used to securitize (the process of transferring the underlying mortgage payments into MBSs) were "antiquated and inflexible."[67] Rather than update two separate systems, FHFA required the Enterprises to jointly develop a platform to facilitate various tasks associated with their securitization processes.[68] The Enterprises entered into a joint venture, Common Securitization Solutions, which acts as a technology service provider for the Enterprises and provides the following services:[69]

"Sunset Provisions on Reps and Warrants: Can They Be More Flexible While Still Protecting the GSEs?," Urban Institute, November 27, 2013, https://www.urban.org/research/publication/sunset-provisions-reps-and-warrants-can-they-be-more-flexible-while-still-protecting-gses.

[63] See FHFA, "FHFA Announces Update for Servicers to Maintain Fair Lending Data," press release, August 10, 2022, https://www.fhfa.gov/news/news-release/fhfa-announces-update-for-servicers-to-maintain-fair-lending-data.

[64] For more information, See FHFA, "Fair Lending Data," https://www.fhfa.gov/data/fair-lending-data.

[65] For more information, see FHFA, "FHFA Announces Validation of FICO 10T and VantageScore 4.0 for Use by Fannie Mae and Freddie Mac," October 24, 2022, https://www.fhfa.gov/news/news-release/fhfa-announces-validation-of-fico-10t-and-vantagescore-4.0-for-use-by-fannie-mae-and-freddie-mac; and CRS In Focus IF12588, *Fannie Mae and Freddie Mac Adopt Alternative Credit Scores*, by Darryl E. Getter.

[66] See written testimony of Edward J. DeMarco, president, Housing Policy Council, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Chairman's Housing Reform Outline*, 116th Cong., 1st sess., March 26, 2019.

[67] FHFA, "Building a New Infrastructure for the Secondary Mortgage Market," October 4, 2012, p. 4, https://www.fhfa.gov/research/papers/building-new-infrastructure-secondary-mortgage-market.

[68] See FHFA, *2015 Scorecard Progress Report*, March 2016, p. 24, https://www.fhfa.gov/sites/default/files/2023-03/progress-report-2015-scorecard.pdf.

[69] The CSP arguably reduces the fixed start-up costs for private guarantors (should they be approved) because they will not have to invest in the technology to perform CSP functions. See written testimony of Mark Zandi, chief economist, Moody's Analytics, U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Chairman's Housing Reform Outline*, 116th Cong., 1st sess., March 26, 2019.

- The Enterprises purchase mortgages from originators, establish separate loss mitigation practices for delinquent and defaulted mortgages for their mortgage servicers to follow, choose the underlying mortgages for placement in each MBS trust, and guarantee the credit risk linked to the MBS trusts they individually create.
- The CSP facilitates the initial issuance of MBSs to investors. After receiving a securitization request from an Enterprise, the CSP validates the details related to the MBS trust and linked MBSs that will be issued to investors (e.g., confirming the mortgages held in an MBS trust, confirming the average principal and interest payment amounts as well as the maturity on the linked MBSs, and confirming the identification code on the security used to facilitate clearing and settlement of trades). Common Securitization Solutions notifies the Enterprises of any data inconsistencies.
- The CSP releases required disclosures for MBS investors. Data about MBSs is sent to the Federal Reserve Bank of New York or the Depository Trust and Clearing Corporation—typically two days before issuance, allowing information about MBSs to be disclosed to market participants—which facilitate the transfer of MBSs to investors in exchange for cash. The CSP confirms issuance and payment information back to the issuing Enterprise.
- The CSP provides ongoing administration of MBSs for investors. For example, the CSP calculates repayments of principal and interest to MBS holders for tax reporting purposes. The CSP provides monthly updates about the prepayment status of the underlying collateral to ensure that investors have current disclosures about information relevant to the linked MBS's performance.

Uniform MBS Single Security Initiative

In the TBA market, a loan originator selling mortgages to the Enterprises contracts to deliver mortgages in exchange for an MBS at a specified future date. Specifically, the MBS buyer (loan originator) and MBS seller (one of the Enterprises) negotiates in advance for future delivery and settlement date for the trade. The buyer and seller agree on six general *features* that the MBS should have: the issuer, maturity, coupon rate, sale price, approximate face value, and settlement date.[70] The exact features of the securities to be delivered are disclosed to the participants two days prior to delivery and settlement.

MBSs that meet the required criteria can be delivered so long as the underlying MBS pools are *fungible*—that is, sufficiently interchangeable with other MBSs. Because the MBS issuer is one of the trading features, MBSs have generally been fungible only with other MBSs issued by the same Enterprise. Fannie Mae–issued MBSs and Freddie Mac–issued MBSs have not previously been interchangeable, and their MBSs do not trade at identical prices despite the fact that the Enterprises have essentially the same federal charters and business (securitization) models.[71]

Prior to the single security initiative, Freddie Mac's MBSs frequently traded at lower prices compared to those issued by Fannie Mae.[72] Following declines in mortgage rates that prompt

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[70] See Vickery and Wright, *TBA Trading and Liquidity in the Agency MBS Market*.

[71] An economic theory known as *the law of one price* states that identical securities should sell for identical prices. See Owen A. Lamont and Richard H. Thaler, "The Law of One Price in Financial Markets," *Journal of Economic Perspectives*, vol. 17, no. 4 (Fall 2003), pp. 191-202.

[72] Laurie Goodman, "The $400 Million Case for a Single GSE Security," Urban Institute, September 5, 2014, http://www.urban.org/urban-wire/400-million-case-single-gse-security.

borrowers to refinance, the mortgage pools underlying Freddie Mac's MBSs historically had faster prepayment rates (relative to Fannie Mae's MBSs). Faster prepayment translates into higher prepayment risk for Freddie Mac MBS investors, which would explain trading at lower prices. Furthermore, a large mortgage originator could subsequently enter into a swap agreement with Fannie Mae to acquire a higher-priced MBS (compared to Freddie Mac) and immediately resell it in the OTC market. Freddie Mac could respond by lowering its g-fees, thereby slightly increasing its MBS coupons relative to Fannie Mae's MBS coupons to remain somewhat competitive. Nevertheless, Freddie Mac's MBS issuances were approximately 70% of Fannie Mae's MBS issuances, and Freddie Mac's MBSs accounted for 9% of total trading activity in 2014.[73] Hence, the pricing differential between the Enterprises' MBSs provided Fannie Mae a competitive advantage in the secondary market over Freddie Mac as well as other prospective private sector securitizers.[74]

Under the single security initiative, FHFA has directed the Enterprises to align their key contractual and business practices by acquiring mortgages with similar prepayment speeds along with other features.[75] The Enterprises may continue to separately purchase conforming mortgages and guarantee the credit risks linked to the MBS trusts they create. Nevertheless, harmonizing the financial characteristics of their mortgage purchases would allow the Enterprises' MBS trusts to generate similar cash flow predictability and prepayment speeds, thus facilitating the creation of uniform and fungible securities when issued through the CSP. The Enterprises would be required to align their prepayment speeds such that they do not constitute a material misalignment or a divergence by more than 2% over a three-month interval.[76]

Rather than separate MBS issuances (i.e., Fannie Mae's MBS and Freddie Mac's participation certificates), FHFA has directed the Enterprises (via the CSP) to issue one common security, the uniform mortgage-backed security (UMBSs). (Private sector guarantors would also be able to use the CSP to issue fungible UMBSs.) FHFA argues that a combined market for the Enterprises' UMBSs would enhance market liquidity and mitigate the rise of market liquidity premiums. The pricing differential would also be eliminated.[77] FHFA monitors both Enterprises to avoid material misalignment that compromises UMBS fungibility.[78] UMBS issuances began on June 3, 2019.[79]

[73] Goodman, "The $400 Million Case."

[74] Laurie Goodman and Jim Parrott, "A Progress Report on Fannie Mae and Freddie Mac's Move to a Single Security," Urban Institute, August 2018, https://www.urban.org/sites/default/files/publication/98872/single_security_0.pdf.

[75] See FHFA, "Uniform Mortgage-Backed Security," 84 *Federal Register* 7793-7801, March 5, 2019.

[76] See FHFA, "Uniform Mortgage-Backed Security."

[77] FHFA, *An Update on the Structure of the Single Security*, May 15, 2015, p. 4, https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Single%20Security%20Update%20final.pdf. For a discussion on the effects of standardization in the mortgage and MBS markets, see Adam J. Levitin and Susan M. Wachter, "Explaining the Housing Bubble," *Georgetown Law Journal*, vol. 100, no. 4 (April 12, 2012), pp. 1177-1258.

[78] The Securities Industry and Financial Markets Association (SIFMA)—a trade association for broker-dealers, investment banks, and asset managers operating in the United States and global capital markets—advocates for legislative, regulatory, and business policies on behalf of their members. SIFMA sets the TBA trading conventions, which includes the TBA settlement guidelines known as the Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities. SIFMA recommends that FHFA, while regulating the mortgage purchasing and trust structuring activities, ensure that the Enterprises do not deviate from the requirements to securitize mortgage originations with standardized borrower characteristics.

[79] See FHFA, "Statement of FHFA Deputy Director Robert Fishman on the Launch of the New Uniform Mortgage-Backed Security (UMBS)," press release, June 3, 2019, https://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-FHFA-Deputy-Director-Robert-Fishman-on-the-launch-of-the-new-Uniform-Mortgage-Backed-Security.aspx.

Post-Conservatorship Operations

FHFA has implemented policies relevant for the operation of the Enterprises that will remain effective post-conservatorship. For example, rather than limiting risk exposure with lending portfolio caps, which are likely to be removed upon termination of the PSPAs with Treasury, the Enterprises will have higher capital requirements. In addition, FHFA has made modifications to the framework and other requirements for the Enterprises' multifamily lending activities. The Enterprises must also demonstrate progress with respect to serving various underserved markets. This section discusses these post-conservatorship policies.

Restoration of Housing Trust Fund and Capital Magnet Fund Cash Contributions

HERA requires the Enterprises to make *cash contributions* to the Housing Trust Fund (HTF) and the Capital Magnet Fund (CMF). The HTF funds states and state-designated entities for eligible activities that primarily support affordable rental housing for low-income families, including homeless families.[80] The CMF awards competitive grants to financial institutions designated as Community Development Financial Institutions and qualified nonprofit housing organizations for which the development or management of affordable housing is one of their principal purposes.[81] The Enterprises must set aside 4.2 basis points (0.042%) of the unpaid principal balance of mortgages purchased in a year for these funds. FHFA suspended the requirement that the Enterprises make contributions to the HTF and the CMF between 2008 and 2014 when they first entered into conservatorship. These requirements were reinstated in 2015.

Heightened Capital Buffer Requirements

Although the precise definitions of *capital* for financial firms is typically determined by laws and regulations, it generally refers to common or preferred equity shareholders (as a percentage of assets) and retained earnings, which can absorb financial losses. For the Enterprises, the statutory minimum leverage (unweighted) capital requirement, specified in the Federal Housing Enterprises Safety and Soundness Act of 1992 (P.L. 102-550), is equal to 2.5% of on-balance-sheet (portfolio) assets and 0.45% of off-balance-sheet (MBS trust) obligations. HERA gave FHFA the authority to increase capital standards above the statutory minimum as necessary.

FHFA suspended the Enterprises' capital requirements during conservatorship, as initially required by the PSPAs with Treasury. The initial PSPAs required the Enterprises to pay Treasury a 10% cash dividend on the amount of the outstanding preferred shares, and dividend payments were suspended for all private Enterprise stockholders. The Enterprises did not have the option to issue additional stock shares or obtain funds elsewhere if they lacked the cash to make full dividend payments to Treasury.[82] On August 17, 2012, therefore, the 10% dividend was replaced with a *profit sweep* dividend requirement, such that all net worth proceeds (that exceeded an initial $3 billion cash buffer that would be reduced annually by $600 million until reaching zero)

[80] After estimating the median family income for designated counties and metropolitan areas, HUD provides annual definitions for *extremely low-income family* and *very low-income family*, which are used to determine eligibility for various programs. See HUD, "Housing Trust Fund," https://www.hudexchange.info/programs/htf/.

[81] See U.S. Department of the Treasury, Community Development Financial Institutions Fund, "Capital Magnet Fund," https://www.cdfifund.gov/programs-training/Programs/cmf/Pages/default.aspx; and Department of the Treasury, Community Development Financial Institutions Fund, "Funding Opportunities: Capital Magnet Fund; 2018 Funding Round," 83 *Federal Register* 34685-34698, July 20, 2018.

[82] See Don Layton, "Temporarily Ending the GSEs Net Worth Sweep: A Limited but Important Step Towards GSE Reform," Harvard University Joint Center for Housing Studies, October 2, 2019, https://www.jchs.harvard.edu/blog/temporarily-ending-the-gse-net-worth-sweep-a-limited-but-important-step-towards-gse-reform.

would be paid to Treasury.[83] The August 2012 PSPAs also required the Enterprises to reduce the size of their lending (retained) portfolios to $250 billion. In 2017, Treasury and FHFA reinstated the capital reserves to $3 billion each to avoid further draws from Treasury by the Enterprises.[84] On September 30, 2019, Treasury further modified the PSPAs to allow Fannie Mae and Freddie Mac to retain earnings and accumulate capital reserves of $25 billion and $20 billion, respectively. On October 28, 2019, FHFA announced a strategic plan to prepare the Enterprises for their eventual exit from conservatorship.

In December 2020, FHFA finalized a rule establishing risk-based and leverage capital requirements for Fannie Mae and Freddie Mac effective on February 16, 2021.[85] The capitalization requirements, which would be in place following the Enterprises' exits from conservatorship, are designed to increase their resiliency to a severe financial downturn.[86] For this reason, the PSPAs were again modified on January 14, 2021, to allow the Enterprises to accumulate the necessary amount of reserves to satisfy the prudential requirements of the 2020 capital rule.[87] In February 2022, FHFA announced amendments to the December 2020 rule specifically to revise the Enterprises' leverage buffer requirements and the risk-based treatment of the CRT exposures, discussed in the textbox below.[88] Compliance with the heightened capital buffer requirements avoids limits on capital distributions and discretionary bonus payments.

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[83] For all the PSPA agreements, see FHFA, "Senior Preferred Stock Purchase Agreements," https://www.fhfa.gov/conservatorship/senior-preferred-stock-purchase-agreements.

[84] A tax revision (P.L. 115-97) would have resulted in anticipated reductions in the Enterprises' deferred tax asset values, discussed in their 2013 Form 10-K reports. See Fannie Mae, Form 10-K for the fiscal year ended December 31, 2013, pp. 3, 80, 143, https://www.fanniemae.com/sites/g/files/koqyhd191/files/migrated-files/resources/file/ir/pdf/quarterly-annual-results/2013/10k_2013.pdf; and Freddie Mac, Form 10-K for the fiscal year ended December 31, 2013, pp. 135, 138, 231, 10-K for the fiscal year ended December 31, 2013, https://www.freddiemac.com/investors/financials/pdf/10k_022714.pdf.

[85] See FHFA, "Enterprise Regulatory Capital Framework," 85 *Federal Register* 243, December 17, 2020.

[86] If, for example, a sudden and significantly sharp decline in house prices generated widespread *underwater* mortgages (held in MBS trusts and in their portfolios), the Enterprises' capital buffers could be insufficient to allow them to continue safe and sound operations. A mortgage is underwater when the home value declines far below the amount of the outstanding loan balance, providing the borrower with the financial incentive to default. See Neil Bhutta, Jane Dokko, and Hui Shan, *The Depth of Negative Equity and Mortgage Default Decisions*, Board of Governors of the Federal Reserve System, May 2010, http://www.federalreserve.gov/pubs/feds/2010/201035/201035pap.pdf.

[87] See FHFA, "FHFA and Treasury Allow Fannie Mae and Freddie Mac to Continue to Retain Earnings," press release, January 14, 2021, https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-and-Treasury-Allow-Fannie-Mae-and-Freddie-Mac-to-Continue-to-Retain-Earnings.aspx. The 2020 capital rule will be discussed in the section of this report titled "Heightened Capital Buffer Requirements."

[88] See FHFA, "FHFA Announces Final Rule Amending the Enterprise Regulatory Capital Framework," press release, February 25, 2022, https://www.fhfa.gov/news/news-release/fhfa-announces-final-rule-amending-the-enterprise-regulatory-capital-framework; and FHFA, "Enterprise Regulatory Capital Framework—Prescribed Leverage Buffer Amount and Credit Risk Transfer," *87 Federal Register* 14764-14772, March 16, 2022.

Highlights of the Enterprise Regulatory Capital Framework

The supplemental capital requirements pertain to both an increase in the quantity of capital (from the statutory P.L. 102-550 requirements) and the composition of the capital.[89] The statutory and supplemental capital definitions constitute the capital regulatory framework with the following broad requirements:

- An unweighted total leverage requirement (UNWLR) of 4% can be computed as the sum of a 2.5% *statutory leverage ratio requirement* and a 1.5% *prescribed leverage buffer amount (PLBA)* under the initial 2020 final rule. Following the 2022 amendment, the PLBA was revised and is currently set to 50% of the *stability capital buffer*, which is one of the components of the *prescribed capital conservation buffer amount (PCCBA)* discussed in the next bullet.
- A risk-weighted *adjusted total capital ratio* (RWCR) of not less than 8% can be computed in what can be described as a three-step process. First, the asset (the loan) is multiplied by a risk weight that is designed to capture the riskiness of the borrower. FHFA provides the risk weights for the single-family and multifamily mortgage exposures depending upon various financial factors (e.g., current LTV, loan purpose, property type, fixed or floating interest rate).[90] Second, the risk-weighted asset (i.e., the product of the original asset multiplied by the risk weight) is multiplied by 8%. Typically, the entire asset side of the balance sheet is risk weighted, and then the risk-weighted assets are summed prior to applying the 8% capital charge. Third, the PCCBA requirements, which adds modifications to the total capital ratio's composition, are applied to achieve the adjusted total capital ratio. As previously stated, the stability capital buffer is one of the adjustments included in the overall PCCBA adjustment.

Thus, the Enterprises now have both unweighted and weighted capital requirements, which has similarities to the capital framework applied to banks. The UNWLR is based upon the balance sheet *size* and represents the maximum loss that can be absorbed by its equity.[91] The RWCR is designed to align proportionately with the gradations of credit risk exposure, presuming accuracy of the risk-weighting system.[92] The RWCR incorporates a minimum common equity ratio requirement to ensure that it consists predominantly of common equity and retained earnings, which have greater loss-absorbing capacity.

The size of the UNWLR relative to the RWCR has implications for a financial firm's risk-taking behavior. For example, when the UNWLR is *lower* relative to the RWCR, a financial firm has a greater incentive to vary the *level* (i.e., scales of operation) of its risk exposure in proportion to its available capital.[93] In other words, the Enterprises could choose to increase or decrease their mortgage purchases under changing macroeconomic circumstances to the extent their RWCRs fluctuate with house prices and business cycles. Furthermore, if recession fears prompt some common equity holders to liquidate their shares (in anticipation of greater mortgage delinquencies and defaults), the Enterprises may react in accord by reducing loan purchases. Hence, the Enterprises' ability to function as a countercyclical macroeconomic buffer would be compromised if they were to provide less liquidity to the mortgage market during recessionary periods.[94]

Alternatively, when the UNWLR equals or exceeds the RWCR, a financial firm has an incentive to alter the *composition* of its risk exposure (via changing business strategies) particularly when its capital is comprised of shareholders primarily focusing on return on equity (ROE). The ROE measures the financial return for shareholders, computed with net income as its numerator and the total amount of common shareholder equity as its denominator. If a firm's net income fails to keep pace with common equity requirements, the ROE may decrease and become less financially attractive for shareholders. A financial firm is likely to respond by increasing its risk exposure, customer fees, or both to boost the numerator and ultimately sustain more attractive ROE levels. In other words, the Enterprises could choose to retain more credit risk (e.g., reducing junior and mezzanine CRT issuances), increasing g-fees on mortgage borrowers, or both when UNWLR exceeds RWCR. The ability to simultaneously transfer some g-fee income to the private sector as compensation for assuming credit risks (via CRT) and maintain acceptable ROEs for shareholders may prove challenging without raising g-fees, resulting in higher mortgage rates for borrowers.

The 2022 amendments to the initial 2020 capital framework addressed the above-mentioned incentive concerns.[95] The initially risk-insensitive PLBA, for example, is now more dynamic and can grow and shrink with an Enterprise's balance sheet, thus lessening the need for an Enterprise to alter its scale of operations when macroeconomic conditions change. Reducing the size of the risk weight initially assigned to CRT exposures from 10% to 5% may be less likely to deter an Enterprise to transfer risk. Nevertheless, predicting the Enterprises' responses following conservatorship under the new capital framework without prior observations of UNWLR and RWCR movements under different interest rate, housing market, and business cycle environments is challenging.

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[89] The final capital regulatory rule adopts terminology and definitions used in the banking capital regulatory framework (continued...)

The Enterprises' Multifamily Business Models

A multifamily mortgage is a loan secured by a residential dwelling, such as an apartment building, with at least five or more separate units. *Multifamily real estate* frequently refers to properties used as residential dwellings, including traditional apartment buildings; subsidized housing; housing for seniors (age-restricted, independent, and assisted living); and housing for students (dormitories). In the multifamily mortgage market, Fannie Mae and Freddie Mac purchase mortgages and transfer a portion (or share) of the default risks to the private sector.[96]

FHFA has issued various directives for the Enterprises' multifamily programs. In 2013, FHFA reduced the Enterprises' new multifamily purchase volumes by 10% from the 2012 caps to shrink their multifamily operations and risks to taxpayers.[97] FHFA subsequently directed the Enterprises to limit their 2014 multifamily purchase volumes at or below the 2013 caps.[98] In 2014, FHFA excluded several business activities from counting toward the cap, which might make it possible for the Enterprises to provide greater support in the affordable housing and underserved market segments before reaching the cap. In 2016, FHFA also excluded loans that would finance certain energy and water efficiency (i.e., green loans) from the multifamily purchase caps. From 2016 to 2018, the Enterprises' share of multifamily lending activities that grew were related to green loans that were excluded from the cap, while those included in the capped declined.[99]

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that many financial stakeholders generally understand to facilitate greater transparency as well as the ability to compare the prudential capital buffers maintained across other classes of financial institutions.

[90] The risk weights are determined using two approaches—a standardized approach and an advanced approach. The standardized approach uses FHFA-prescribed lookup grids and risk multipliers. The advanced approach relies on each of the Enterprises' internal models. The approach generating the higher risk-weighting is used when determining risk-based capital requirements.

[91] Leverage ratios are designed to become more binding when the economy is growing and less binding when the economy contracts. See Michael Brei and Leonardo Gambacorta, *The Leverage Ratio Over the Cycle*, Bank for International Settlements, November 2014, http://www.bis.org/publ/work471.pdf.

[92] The reliability of risk-weighted capital ratios depends upon the accuracy of the risk-weighting system, which typically assigns lower weights to assets (e.g., cash, U.S. Treasury securities) deemed to have little or no credit risk and higher weights to assets (e.g., mortgages) and financial exposures (e.g., credit risk linked to underlying mortgage assets) deemed to have greater amounts of credit risk.

[93] The lower UNWLR functions as a backstop if the assigned risk weights used to calculate the RWCR underestimate the credit risk exposure. See Paul Glasserman and Wanmo Kang, *Design of Risk Weights*, Office of Financial Research, August 19, 2014, https://www.financialresearch.gov/working-papers/2014/08/19/design-of-risk-weights/.

[94] See Edward Golding, Laurie Goodman, and Jun Zhu, "Analysis of the Proposed 2020 FHFA Rule on Enterprise Capital," Urban Institute, August 2020, https://www.urban.org/sites/default/files/publication/102779/analysis-of-the-proposed-2020-rule-on-enterprise-capital_2.pdf.

[95] See FHFA, "Fact Sheet: Final Rule to Amend the Enterprise Regulatory Capital Framework," https://www.fhfa.gov/sites/default/files/2024-05/Fact-Sheet-Final-Rule-CRT_2252022.pdf.

[96] For more information on multifamily mortgage finance as well as the Enterprises' underwriting and risk-sharing models, see CRS Report R46480, *Multifamily Housing Finance and Selected Policy Issues*, by Darryl E. Getter.

[97] See FHFA, "FHFA Seeks Public Input on Reducing Fannie Mae and Freddie Mac Multifamily Businesses," press release, August 9, 2013, https://www.fhfa.gov/news/news-release/fhfa-seeks-public-input-on-reducing-fannie-mae-and-freddie-mac-multifamily-businesses.

[98] The 2013 volume that became the 2014 cap for Fannie Mae was $30 billion. The 2013 volume that became the 2014 cap for Freddie Mac was $26 billion. See Karan Kaul, "The GSEs' Shrinking Role in the Multifamily Market," Urban Institute, April 2015, https://www.urban.org/sites/default/files/publication/48986/2000174-The-GSEs-Shrinking-Role-in-the-Multifamily-Market.pdf.

[99] See FHFA, "Fact Sheet: New Multifamily Caps for Fannie Mae and Freddie Mac," https://www.mortgagetranslations.gov/sites/default/files/2023-03/newmultifamilycaps-9132019.pdf.

On September 13, 2019, FHFA revised its directive regarding the multifamily purchase caps, increasing them from the 2018 caps of $35 billion each to $100 billion each for Fannie Mae and Freddie Mac.[100] Moreover, 37.5% of the Enterprises' loan purchases must be mission driven. By purchasing mission-driven multifamily mortgages that support affordable rental housing, the Enterprises are less likely to *crowd out* (impede) private sector lender participation by offering cheaper borrowing rates for multifamily loans.[101] All multifamily mortgage purchases count toward the cap—no exemptions or exclusions.[102] In short, FHFA's revised policy is designed to prevent the Enterprises' multifamily programs from growing without a more explicit link to affordable rental units for low- and moderate-income and other historically underserved renters—while making a *reasonable* economic return—rather than crowd out private sector lending activities in market segments with less apparent credit gaps.[103]

On December 14, 2022, FHFA finalized a rule to establish the benchmark levels for multifamily housing goals using a new percentage-based methodology.[104] The three subgoals are each established as a percentage of the total number of affordable multifamily properties financed by the GSEs each year. Because new developments may occur over the period that can increase the infeasibility to meet a housing goal defined in terms of units, the percentage-based methodology lessens the need to amend the benchmarks after publication of the final rule.

The FHFA also provided an updated comprehensive definition of *mission-driven multifamily purchases*.[105] Examples of additional eligible mission-driven mortgage purchases for the GSEs include properties subsidized by the Low-Income Housing Credit program; loans on properties covered by Section 8 Housing Assistance Payment contracts, which limit tenant incomes to 80% or below of the Area Median Income; and loans of properties in which a Public Housing Authority or nonprofit affiliate is the developer (borrower) that reserves units for occupancy by tenants with limited income or the rents that may be charged for those units.[106]

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[100] See FHFA, "FHFA Revises Multifamily Loan Purchase Caps for Fannie Mae and Freddie Mac," press release, September 13, 2019, https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Revises-Multifamily-Loan-Purchase-Caps-for-Fannie-Mae-and-Freddie-Mac.aspx.

[101] See FHFA, "Fannie Mae and Freddie Mac Multifamily Businesses," https://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Reducing-Fannie-Mae—Freddie-Mac-Multifamily-Businesses.aspx.

[102] For example, exemptions for multifamily loans used to finance energy and water improvements still count toward the cap. See Kathleen Howley, "FHFA Moves to Curb Fannie Mae, Freddie Mac Green Loans for Multifamily: Regulator Raises Lending Caps for GSEs but Ends the Energy-Efficiency Carve-Out," *Housingwire*, September 13, 2019, https://www.housingwire.com/articles/50147-fhfa-moves-to-curb-fannie-mae-freddie-mac-green-loans-for-multifamily/.

[103] The Enterprises' statutory public purpose includes an "affirmative obligation to facilitate the financing of affordable housing for low- and moderate-income families in a manner consistent with their overall public purposes, while maintaining a strong financial condition and a reasonable economic return." See 12 U.S.C. §4501(7). Both Enterprise charters authorize them to perform "activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities." See 12 U.S.C. §§1451, 1716 note.

[104] FHFA, "FHFA Finalizes 2023-2024 Multifamily Housing Goals for Fannie Mae and Freddie Mac," press release, December 14, 2022, https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Finalizes-2023-2024-Multifamily-Housing-Goals-for-Fannie-Mae-and-Freddie-Mac.aspx; and CRS Report R46480, *Multifamily Housing Finance and Selected Policy Issues*, by Darryl E. Getter.

[105] FHFA, "FHFA Revises Multifamily Loan Purchase Caps for Fannie Mae and Freddie Mac—Appendix A: Multifamily Definitions," press release, September 9, 2019, https://www.fhfa.gov/Conservatorship/Documents/AppendixA-Revisions-to-2019-FHFA-Conservatorship-Scorecard.pdf.

[106] See CRS Report RS22389, *An Introduction to the Low-Income Housing Tax Credit*, by Mark P. Keightley; and CRS Report RL34591, *Overview of Federal Housing Assistance Programs and Policy*, by Maggie McCarty, Libby Perl, and Katie Jones.

Prior to conservatorship, the Enterprises' multifamily business activities were arguably diversified such that cash flows from some lending activities could offset cash-flow disruptions stemming from other lending activities. Because low- and moderate-income tenants have greater difficulty paying market-level rents, mortgages used to finance these multifamily structures may experience greater cash flow disruptions. If FHFA's requirements pertaining to multifamily caps were to remain intact upon exit from conservatorship, the Enterprises' multifamily portfolios may exhibit greater cash flow volatility if a larger share of their multifamily lending activities are heavily concentrated in certain mission-related activities.[107] In other words, limiting the Enterprises' involvement in certain activities may present a challenge for them to make an economic return that shareholders would also find reasonable.

Duty to Serve: Manufactured Housing Chattel Loans

HERA created a *duty to serve* for the Enterprises with respect to three underserved markets: manufactured housing, rural housing, and affordable housing preservation. Supporting manufactured housing—particularly in underserved communities—is considered to be an affordable option. This option, however, poses several challenges for the Enterprises.

Manufactured housing involves *chattel* lending, which differs from real property lending. A manufactured home is a factory-built home that is transportable in one or more sections; has been constructed after June 15, 1976; and is built on a permanent metal chassis and must meet the safety standards set by the U.S. Department of Housing and Urban Development.[108] Mortgage loans can be used to finance homes that are permanently attached to real property.[109] By contrast, manufactured home *chattel loans* are used to finance personal property (chattel) that is not permanently attached to land. Because the cost to purchase a manufactured home is typically far below the cost to purchase a site-built home, a manufactured home may be a viable affordable housing option for low-income borrowers.[110] By facilitating liquidity to the chattel market, the Enterprises can make progress toward achieving all three duty-to-serve goals, because manufactured homes are disproportionately located in nonmetropolitan areas occupied by residents with lower incomes or net worth.[111] The Enterprises have noted, however, that pursuit of

[107] Multifamily mortgages are underwritten based on the current and anticipated cash flows—predominantly in the form of rental income—generated by the properties. If the tenants in multifamily properties are cost-burdened, meaning that their monthly housing (rent) costs exceed 30% of their income, then the rental income streams necessary to repay loans may exhibit greater volatility, thus increasing the Enterprises' cash-flow volatilities and loss risks. For more information, see CRS Report R46480, *Multifamily Housing Finance and Selected Policy Issues*, by Darryl E. Getter.

[108] By contrast, a manufactured home built before June 15, 1976, that does not meet HUD standards is referred to as a mobile home. Few lenders are willing to provide loans to finance mobile homes. In contrast to mobile and manufactured homes, a modular home is constructed to the same state, local, or regional building codes as site-built homes. See HUD, "Frequently Asked Questions for On-Site Completion of Construction of Manufactured Homes," https://www.hud.gov/program_offices/housing/rmra/mhs/faqs. Moving a manufactured home from a permanent site to another one may interfere with its loan financing. Thus, modular homes may be considered better investments. See American Financing, "What Is a Chattel Mortgage?," https://www.americanfinancing.net/mortgage-basics/chattel-mortgage.

[109] See Fannie Mae, "Key Legal Distinctions Between Manufactured Home Chattel Lending and Real Property Lending," June 29, 2018, https://www.fanniemae.com/media/28481/display.

[110] See FHFA, "Fannie Mae and Freddie Mac Support for Chattel Financing of Manufactured Homes Request for Input," January 2017, https://www.fanniemae.com/media/28481/display.

[111] See Consumer Financial Protection Bureau (CFPB), "Manufactured-Housing Consumer Finance in the United States," September 2014, https://files.consumerfinance.gov/f/201409_cfpb_report_manufactured-housing.pdf.

their duty-to-serve obligations contains substantial risks that may adversely affect their financial results and conditions.[112] Providing support for chattel loans includes the following challenges:

- Lenders generally show more willingness to provide loans for manufactured homes titled as real property. For one reason, recovering losses if a borrower defaults on a chattel loan is more difficult. Suppose, for example, a borrower leases rather than purchases the land beneath the manufactured home titled as personal property, which may be an affordable option for a low- or extremely low-income household. If a borrower defaults on a chattel loan, then the lender can repossess the property peaceably as a repossession or through a replevin lawsuit.[113] If, however, the borrower is also delinquent on the land lease, then re-marketing a repossessed manufactured home—either on its current site or if it must be moved to another site—adds more legal complications and expenses likely to further reduce the amount of losses that may be recovered.[114]
- Manufactured homeowners typically pay higher annual percentage rates—the total cost of a loan (both the interest rates and transaction fees)—for their loans in comparison to site builders.[115] The Enterprises have prohibited purchases of high-cost loans that are consistent with their missions to facilitate affordable housing. Certain consumer protections that exist when dwellings are attached to land, however, do not apply to chattel loans. For example, the integrated disclosures requiring lenders, mortgage brokers, or servicers of home loans to disclose loan pricing information to borrowers do not apply when the dwelling is not attached to land.[116] Fewer disclosures may lead to greater uncertainty about the extent that borrowers could have received cheaper financing or were aware of less costly financing alternatives.
- Securitizing chattel loans is challenging. Chattel loans cannot be placed in the same pools with other mortgages linked to UMBS issuances, which have strict prepayment speed requirements and homogenous credit risks. Secondary market security issuances linked to chattel loans must be structured from pools consisting only of chattel loans—more likely to have homogeneous financial risks—to enhance investors' understanding of the likely performance of their investments, which may not be economically feasible.[117] Thus, the collection of performance data to better understand the prepayment and default risks pertaining to chattel loans may help determine how to create secondary market securities that investors may find attractive.

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[112] See Fannie Mae, Form 10-K for the fiscal year ended December 31, 2019, p. 31, https://www.fanniemae.com/sites/g/files/koqyhd191/files/migrated-files/resources/file/ir/pdf/quarterly-annual-results/2019/q42019.pdf; and Freddie Mac Form 10-K for the fiscal year ended December 31, 2019, p. 152, https://www.freddiemac.com/investors/financials/pdf/10k_021320.pdf.

[113] See Justia, "Foreclosures of Manufactured Homes," https://www.justia.com/foreclosure/foreclosures-of-manufactured-homes/.

[114] See Fannie Mae, "Key Legal Distinctions."

[115] According to the CFPB, a chattel loan may be priced between 50 and 500 basis points higher than a mortgage loan for a manufactured home secured by real property. See CFPB, "Manufactured-Housing Consumer Finance."

[116] See CFPB, "CFPB Consumer Laws and Regulations: Regulation X Real Estate Settlement Procedures Act," https://files.consumerfinance.gov/f/201503_cfpb_regulation-x-real-estate-settlement-procedures-act.pdf.

[117] Large-scale operations such as the Enterprises may not have the volume of similar chattel loans necessary to offer pools for securitizations. See Fannie Mae, *Duty to Serve Underserved Markets Plan*, revised January 9, 2024, https://www.freddiemac.com/sites/g/files/ynjofi111/files/about/duty-to-serve/docs/Freddie-Mac-Underserved-Markets-Plan.pdf.

Fannie Mae and Freddie Mac are developing plans to provide liquidity for manufactured housing titled as chattel through securitization channels.[118] FHFA has given the Enterprises permission to implement their chattel financing initiatives as pilot programs.[119] Nevertheless, FHFA also considers manufactured housing to contain higher credit and liquidity risks. In the final rule establishing the Enterprises' heightened capital requirements, the manufactured home loan category is assigned one of the higher risk weights relative to other types of mortgages. If the Enterprises enter into the chattel lending markets, FHFA might introduce a separate risk weight that could be higher than the current risk weight for manufactured homes titled as real property.

The Federal Home Loan Bank System and Chattel Loans

The Federal Home Loan Bank (FHLB) System, which is also a housing GSE with an affordable housing mission that is supervised by FHFA, has addressed issues pertaining to the higher levels of default risk associated with chattel loans.[120] Lenders may face limitations obtaining advances (short-term loans) from some of the FHLBs using chattel loans as collateral, as different FHLBs may have separate policies.[121] FHFA, however, allows the FHLBs to purchase chattel loans under their Acquired Member Assets programs, although they have made few if any such purchases from member financial institutions.[122]

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[118] See Fannie Mae, "What Is Duty to Serve?," https://www.fanniemae.com/media/45201/display; and Freddie Mac, "Duty to Serve," https://sf.freddiemac.com/working-with-us/affordable-lending/duty-to-serve/overview.

[119] See FHFA, "Enterprise Duty to Serve Underserved Markets," 81 *Federal Register* 96242-96301, December 29, 2016.

[120] See CRS Report R46499, *The Federal Home Loan Bank (FHLB) System and Selected Policy Issues*, by Darryl E. Getter.

[121] The FHLBs may require a manufactured home to be converted from personal property to real property before any loan to secure the property can be used as collateral for a loan to its member lending institutions. For example, see FHLBank Atlanta, *Loan Collateral Resource Guide*, http://corp.fhlbatl.com/files/documents/loan-collateral-resource-guide.pdf.

[122] See FHFA, "Federal Home Loan Bank Housing Goals Amendments Final Rule," June 25, 2020, https://www.fhfa.gov/SupervisionRegulation/Rules/Pages/Federal-Home-Loan-Bank-Housing-Goals-Amendments-Final-Rule.aspx. The Mortgage Purchase Program and the Mortgage Partnership Finance Program are two types of Acquired Member Assets programs. For more information, see FHFA, "Fact Sheet: Final Rule on Federal Home Loan Bank Housing Goals," https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/FHLBank-Housing-Goals-Fact-Sheet-Final-rule.pdf.