GSE Activity Report

Monday, December 16, 2019

The Fickle Finger of FSOC

Summary

As we noted last week, Treasury's Financial Stability Oversight Council (FSOC) has not only finalized its new systemic-designation process, but also targeted nonbank originators and servicers for near-term consideration. Here, we go deep into the new systemic framework to anticipate how FSOC may now proceed. As before, we expect activity-and-practice designation that leads to near-term liquidity buffers for big banks and servicing backstops at the GSEs. However, one-off designations for the largest nonbanks are also possible, although not probable.

Impact

As a forthcoming in-depth FedFin report will address, FSOC on December 4 finalized a little-changed version of its proposed guidance on nonbank systemic designation. FSOC abandoned the Obama Administration's approach to nonbank systemically-important financial institutions (SIFIs) in favor of an activity-and-practice approach that targets high-risk activities in hopes of a regulated sector, not one-off standards with resulting competitiveness and structural misalignment.

However, as FHFA Director Calabria was at pains to reiterate, FSOC can still designate individual companies. We have long said and continue to note here that Fannie and Freddie might be designated as SIFIs, but only after conservatorship and then only if FHFA wants to bring successor companies under the Fed – a jurisdictional sacrifice few agencies are likely to welcome.

Regardless, the near-term issue isn't the fate of Fannie and Freddie, but nonbank mortgage companies. Under the final guidance, an activity or practice may be designated as systemic if the following are problematic and risk mitigation is deemed insufficient: asset-valuation or credit risk, leverage, liquidity risk, counterparty risk, interconnectedness, opacity, operational risk, volatility or trading risk. This list is based on Section 120 in the Dodd-Frank Act, which creates the activity-and-practice designation authority, but it omits several key criteria: all of those that also permit designation if an activity, product, or practice is harmful to low-and-moderate income communities or other underserved groups.

In sharp contrast, firm-designation authority in the final FSOC guidance retains the statute's consumer-protection provisions. The new approach does differ from law in that it makes activity-and-practice designation the default option in case of perceived systemic risk. Further, SIFI designation is allowed only if FSOC decides that this is insufficient to address looming harm or if a threat arises at a firm outside the reach of financial regulators (presumably here meaning state or federal). However, consideration is to be given not only to systemic risk defined along the lines used for activity-and-practice designation, but also if a company is critical to underserved or LMI households. As a result,

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FSOC could – but we doubt will – designate one or more of the very largest nonbanks even if systemic risks are rebuttable on grounds of risk to LMI households or others in the event of the sudden mortgage-liquidity shocks described in last week's FSOC report.

Outlook

What all this means is that nonbank originators and servicers could be designated by FSOC as either problematic product providers or targeted firms. Based on the above along with the details in the final guidance, we expect activity-and-practice designation focusing primarily on insulating banks from liquidity risk related to nonbank draws, protecting the GSEs from undue defaults due to defective servicing, and protections implemented through FHA and Ginnie Mae to protect both the taxpayer and mortgage-market liquidity under stress. Details matter, of course, but these are the options that most readily address FSOC's fears along with all of those outlined by FHFA and the banking agencies.

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