GSE Activity Report

Tuesday, August 13, 2020

Running Aground on the Refis

Summary

The GSEs' decision last night to charge a 50 bps refi fee epitomizes the impact of capital regulation: with private-sector capital incentives come private-sector capital reallocation actions. This fee is fueling a still more ferocious firestorm surrounding FHFA's proposal, but we continue to expect FHFA to finalize it as quickly as possible to create a new GSE reality regardless of the election's outcome.

Impact

The refi boom has clearly forced Fannie and Freddie to take preemptive action ahead of finalization, realigning strategy much as U.S. banks did from 2010 through 2015 as the post-crisis capital framework was formulated. Indeed, the GSEs have an even more powerful impetus to realign ahead of finalization because the combination of ultra-low rates and macroeconomic shock has created a risk paradigm of unprecedented proportions. Refis have reached record levels even as COVID resurgence is stifling recovery across the country. With the end of fiscal-stimulus talks earlier this week, a lot of refis at what may well prove the height of house pricing heading into what could be a deep recession is on its own a high-risk proposition.

However, the capital rule complicates matters. Even if the GSEs were willing to put their backs behind high-risk refi guarantees, Fannie's decision to hold off on CRTs and Freddie's to do only selected issuances means that they will take all the risk of whatever they do now. This is already capital-intensive, but planning ahead for the capital rule for mortgage purchases makes it still more so – as we noted, the FHFA rule includes a counter-cyclical capital charge for top-of-cycle mortgage risk. All of the new refis are of course surely that and, based on LTV and other factors, likely trigger other new FHFA capital costs as well.

All of these capital costs taken together may be less than those applied to banks for like-kind mortgage risk, but for Fannie and Freddie, they are not only meaningful, but also problematic. Scant current capital reserves combined with an array of other stresses may thus have persuaded the GSEs to take the risk-mitigation and capital-conservation action announced late last night.

Why did the GSEs do so for refis and not purchase loans? As we noted last September, the Administration and FHFA view refis as extra-mission activities. Purchase-money mortgages – not refis – are the GSEs' charter obligation, according to their read of both the law and public policy.

Outlook

The GSEs' decision makes it clear – if it weren't clear enough already – that Fannie and Freddie will prioritize capital preservation over balance sheet risk taking. We cannot speak to the risk the GSEs are seeing on the refis purchased during the second quarter or those emerging in the July book, let alone what's to come in the absence of continuing unemployment insurance and stimulus payments. Whatever it is, Fannie and Freddie intend to be sufficiently capitalized to absorb it as well as to maintain purchase-mortgage capacity over the third and fourth quarters – one view of their mission, but clearly a view FHFA endorses.

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