GSE Activity Report

Thursday, January 18, 2018

What Watt Wants

Summary

In this analysis, we appraise Director Watt's totally leaked plan for the GSEs which, while deferential to Congress, is nonetheless clearly aimed at setting a baseline from which Senate Banking's bill proceeds. Consistent both with recent Watt statements and longstanding FHFA priorities, the key to the plan is converting the conservatorships into privately-held utilities, an approach we have long suggested would likely prove the most feasible transition strategy. However, lest GSE investors continue to jump for joy, it's important to remember that a necessary condition Watt proposes – robust capital and liquidity standards – means that earnings will be a long, long time a 'coming for new-style GSEs. Further, as detailed below, numerous complex transition questions may well require near-term USG guarantees not backed by private capital. This is a practical necessity of the Watt plan but not only an obstacle to near-term private profit, but also immediate political viability in the House.

Impact

Premised on FHFA's political objectives such as maintaining the 30-year FRM, appeasing small mortgage lenders, doing something about affordable housing, and figuring out what to do with all the infrastructure the GSEs have been forced to build, the Watt plan includes the following key elements:

- SMEs: The plan converts the GSEs to "secondary-market entities" (SMEs). SMEs would provide an MBS backstop under a regulated rate of return and stringent prudential and activity standards. FHFA or its successor would charter SMEs, with FHFA positing at least two. We suspect there will be only two because any GSE challengers will be very difficult to develop other than through consortia of large banks that will face both policy and political obstacles. Indeed, FHFA clearly hopes for a just-two structure by posting that there shouldn't be a lot of SMEs to prevent "a race to the bottom" and that all chartered SMEs should have substantial economies of scale.
- SME Structure: The SMEs would have to use the common securitization platform and issue a single RMBS, further challenging more than two SMEs that aren't GSE redos. While all SMEs would have the same mandated rate of return (somehow set by the Congress or the FHFA to make investors happy and mortgages affordable), the rate could also vary by product type to permit subsidized affordable mortgages. Pricing the rate of return to accomplish all these policy goals, retain capital, promote affordable housing, and make investors happy will be some neat trick.
- SME Activities: SMEs could engage in both single- and multi-family guarantee activities, but the catastrophic-risk backstop would apparently apply in both cases. SMEs would also be

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required to engage in credit-risk transfers, with the regulator stipulating resulting capital relief and – for the first time – establishing a counter-cyclical structure to ensure continuing CRTs under stress scenarios.

- USG Guarantee: The government would provide a paid-for, explicit catastrophic-risk guarantee beneath the SME's credit enhancement. This taxpayer backstop would apply only to guaranteed MBS, not the SMEs. Funding for it would come from a "mortgage-insurance fund" (MIF) with few details provided on how the MIF would function. Prior proposals compared it to the FDIC premium structure, but the FDIC's risk-based assessment approach and other technical details challenge the MIF's design, cost, and impact on SME viability. Who takes the USG's risk while the SMEs and MIF are ramping up is an unanswered question, but not exactly a small one either for investors or politicians.
- Affordable Housing: FHFA says the SMEs need to be of a national scale so that they can effectively price affordable-housing products without subsidy or undue risk. Affordability requirements would apply in return for the USG backstop. Notably, the plan would also allow the SMEs to hold affordable loans not ready for securitization on their portfolios. The plan doesn't say if the MIF and USG backstops would apply to these portfolio loans, but it does indicate that portfolios could grow large in stress scenarios with illiquid secondary markets. Expect Chairman Hensarling not to like this so much.
- Transition: The SMEs obviously solve for some transition problem by a relatively straightforward transformation from the conservatorships, but this is only by comparison to other approaches (e.g., GSE liquidation). FHFA also contemplates a way to make current GSE MBS fungible with new-style issuance, likely through some sort of a wrap with an MIF-backed enhancement. Given how long it could take to ramp up the MIF, the mechanics here will be very challenging.
- Small Lenders: The usual level-playing field, fair-pricing, and similar rhetoric is in the FHFA plan. However, the plan also contemplates SME offers and USG backstops for the cash window, and loan-aggregation operations.
- Loss Mitigation: The SMEs would be able to buy delinquent or defaulted loans to provide loan-modification or other relief and thus reduce potential MIF and taxpayer loss.

Outlook

The Senate Banking Committee could punt on a lot of these details and thus craft a compromise bill with considerable prospects in the Senate, but we doubt Hensarling will be as sympathetic. Republicans will like the SME idea, but want to open it up to more companies under fewer activity restrictions. However, all bills will, we think, retain the bank-like capital construct in FHFA's plans, a tough approach that will make SMEs outside of the conservatorships very challenging from the perspective of any investor hoping to see its money back before the next millennium. Going from the GSE's $3 billion capital cushions to enough capital to be credible against books of, say, $2.5 trillion per SME, is a long, long road.

MIF start-up costs and resulting USG exposure are also non-trivial considerations. All of these make the Hensarling government-corporation construct a quicker start-up, but one FHFA apparently opposes due to the damage it does to the GSEs and all the infrastructure FHFA has forced them to build over the past ten years.

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