GSE Activity Report

Tuesday, May 15, 2018

What It Takes

Summary

As we have noted in prior reports, any successors to Fannie Mae and Freddie Mac with any hope of mobilizing private-sector capital for mortgage finance need to do so with eyes wide open as to the regulatory and business-model constraints governing the globe's biggest banks. Although a new paper from the Milken Institute Center for Financial Markets and OECD looks at development finance – not mortgages – its findings are directly germane to how guarantees must be structured if a new agency hoping for private-capital participation has any hope of sustaining a $10 trillion housing market. Although the study does not address complex structuring questions such as credit-risk transfers, its findings nonetheless make it clear that the global financial market will support large volumes of U.S. housing finance only if backstop guarantees are unconditional, claim-payment certain, and otherwise advantageous under applicable capital and liquidity rules under CECL-accounting conditions. Making this happen with a governmental or quasi-governmental guarantor is hard enough, as this paper demonstrates; doing it only with private capital is impossible.

Impact

The Milken/OECD paper tries to answer a development-finance question critical also to any new-style U.S. residential-mortgage market: what does it take to get private-sector capital to supplement public-sector resources. The answer is simply that policy-oriented products must meet applicable regulatory and business-model constraints – seemingly obvious, but overlooked in most discussions of GSE reform of which we are aware.

The first key finding germane to residential finance comes from survey research in which large financial institutions were asked about what it would take to get them to put hard dollars into development finance. Guarantees were far and away the preferred financial instrument for blended products – i.e., those with a mix of public and private capital. In general, respondents favored guarantees over insurance backstops. Much of the paper is thus dedicated to urging the World Bank and other organizations to step back from direct lending to use their resources more efficiently through guarantees. No position is taken on recent catastrophe bonds issued by the World Bank for pandemics and similar coverage.

Turning to regulatory issues, the paper matches the capabilities of development-finance agencies with the global capital and liquidity rules to find that guarantees must be unconditional, paid without forcing the beneficiary first to pursue payment from the borrower, fixed in cost regardless of changing risk, and pay *pro rata* even if all claims are not covered. To ensure a broad international market,

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guaranteed obligations should also be issued by the World Bank or a similar agency whose obligations are eligible for favorable treatment under the Basel liquidity rules (i.e., the guaranteed loan or bond is a high-quality liquid asset under the LCR) and provide a clear claim against the guarantor and coverage of payment shortfalls.

Moving on from the rules to bank business models, the paper agrees with our longstanding conclusion that the largest banks are evolving to a fee-based strategy because the capital and liquidity costs of large on-balance sheet obligations are prohibitive. Even with eligible guarantees meeting all the conditions above, bank balance-sheet capacity for whole loans or for issuing guarantees on other obligations is limited due to credit-exposure and related limitations. As a result, the Milken/OECD paper looks to see what it would take to get big banks to originate paper backed by development authorities and then syndicate or otherwise distribute bonds to institutional investors. For this to occur, instruments cannot be one-offs – banks need to have a large enough supply of obligations meeting all the conditions above that they can not only book, but also have confidence will meet a broad, liquid, and low-cost secondary market. Products with inherent variations, seasonal demand, event-related default triggers, or long periods before claims payment will face particular obstacles developing deep secondary markets, but all development finance aimed at institutional investors needs careful structuring and appropriate pricing.

Outlook

Particularly striking about this paper is that it does not, as many have, argue that the best way to get private capital to support public purpose is to cook the regulatory books. The EU is for example contemplating changing risk weightings in its capital rules to support sustainability and infrastructure finance and there have long been calls in the U.S. to do the same for other favored sectors. Indeed, the U.S. risk-based capital rules already do alter weightings for social-policy purposes, providing a bit of slack for low-LTV mortgages and small-dollar loans to small businesses. Going farther to define overall asset classes that meet policy needs and then lower capital requirements will of course move the money, but do so at considerable risk not only to institutions holding these discounted but potentially high-risk obligations, but also the broader concept that governments should not allocate capital without putting themselves at least as much at risk as the private investor.

What this paper shows is that risk weightings and liquidity rules can retain their integrity for development finance – and thus also for mortgage finance – if products respect regulatory constraints and that this type of product design is viable as long as a guarantor is a governmental or quasi-governmental agency already favored under the capital and liquidity rules. When credit-risk transactions do not respect these regulatory realities, they can find a market – GSE credit-risk transfers have – but these markets will remain niche ones comprised of non-institutional investors – i.e., the hedge funds snapping up CRTs. Only with long-term commitment from institutional investors can multi-trillion dollar stable, liquid markets meet public purpose, and so this paper shows again.

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