GSE Activity Report

Tuesday, November 24, 2020

Winners and Losers

Summary

Building on our analysis of the overall final FHFA capital rule, we turn here to an assessment of the rule's strategic impact. Although much will be different due to the new rules in terms of GSE ROE, ROA, and product choice, the capital advantages still afforded the GSEs ensure they will remain the defining force in U.S. housing finance for the foreseeable future in or out of conservatorship. To the extent the Biden Administration is able to change FHFA's standards, this will only be more true, although product-by-product and structure-by-structure configurations will realign following a policy shift against risk-based pricing, towards express affordability standards, and in more favor of capital markets products for risk transfer. A Yellen Treasury will be still more demanding of systemic designation outside conservatorship along with supporting a quasi-fiscal role for Fannie Mae, Freddie Mac, and the FHLBs.

Analysis

The final rule provides more comparative data than the NPR, but we find it hard to draw firm conclusions beyond the fact that the GSEs will continue to enjoy significant capital benefits over banks – especially the largest ones – when it comes to like-kind mortgage guarantee and securitization activities. For as long as the GSEs' funding costs benefit from the formidable double-whammy of an implicit or effective guarantee and the Fed holding trillions in agency paper, the capital edge remaining under this rule tilts the playing field in anything conventional or conforming still more steeply in their favor.

We draw this conclusion despite significant challenges following FHFA's analytics because what we can tell from FHFA's calculations makes it clear that FHFA's methodology surely underestimates like-kind capital if a big bank had a portfolio akin to Fannie's or Freddie's. FHFA says that the final rule would have cost the GSEs $283 billion in total risk-adjusted capital before CRT discounts as of June 30, with the buffers necessary to avoid distribution-and-bonus restrictions adding an unspecified additional total to this bottom line. Had the GSEs been subject to the "bank capital framework," this would have been $450 billion, but FHFA does not make it clear if this total derives from the standardized rules governing most banks or the GSIB standards which may be a more apt comparison in terms of systemic risk.

The leverage-ratio totals are still more tilted towards the GSEs because of the risk-based totals on which FHFA set its ratio. It says that the GSEs' LR is 81% of large banks based on a 50% RWA for mortgages and a 4% big-bank LR, but the actual LR for the biggest banks is 5% under the most generous reading of the rules and much of their LR totals comes from all the 0% assets on the big

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bank's books.

It's also unclear if stress-tested buffers are taken into account in order to do the true comparison of capital rules necessary to avoid distribution-and-bonus constraints (the rule says the bank total is restriction-free, but this varies so much for different types of banks that it's hard to know what is actually meant). FHFA does say that the bank total of $450 billion excludes market and operational risk capital – plus or minus about 15% of big-bank rules, although it appears that it's GSE totals include these requirements under the final rule.

All of the numbers detailed above are, though, just factors in an equation that ends with a price calculation. Many commenters argued that the proposal would lead to a significant hike in g-fees – Freddie for example posited increases of up to 35 bps. FHFA acknowledged the g-fee concerns but essentially discounted them on grounds that competition would dictate pricing even as the agency readily acknowledges that Fannie and Freddie are a duopoly for purposes of most of the rules' toughest love.

Under FHFA's likely plan – i.e., as quick an end to the conservatorship as possible under the toughest possible capital-restoration plan – g-fees could well mount to the levels feared in many comment letters, but the capital edge afforded Fannie and Freddie, their funding-cost advantage, the GSEs' edge in capital benefits due to MI, and the lower costs associated with nonbank origination and servicing due in large part to other bank rules would still give them a significant edge over any new channels for conventional, conforming paper versus large U.S. banks.

The real challenge in terms of lost business would arise for nonbanks to the extent higher g-fees at higher interest rates reduce borrower affordability. We think this is a minimal constraint at record low interest rates – the real challenges to LMI home ownership are masked in aggregate g-fee totals as long as LLPAs and other disincentives apply. However, when rates rise – someday, sometime – market shifts would ensue or – more likely – loan volume would drop via the GSEs and move to FHA.

Outlook

We will shortly complete our analysis of Janet Yellen's views on housing, our forecast of how these fit into her strong views on financial structure and systemic risk, and what these mean for U.S. housing finance. As always, the imponderable is the extent to which Director Calabria and Secretary Mnuchin hand the Biden Administration a *fait accompli* in terms of an end to the GSEs' conservatorships – we hold to our forecast that they will do everything they can to do so. However, even if the Trump team is able to take the most critical charter question away from Mr. Biden, the new White House, Treasury, and Fed will nonetheless have considerable scope for strategic realignment across the U.S. housing-finance system once the COVID crisis ebbs and the bodies left on the beach wash up on their shore.

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