



GSE Activity Report

Monday, December 28, 2020

You're On Your Own – Sort Of

Summary

As we [noted](#) last week, FHFA is barreling through the systemic rulebook, finalizing [capital rules](#), proposing [liquidity standards](#), and, now, laying out [living-will requirements](#) to ensure orderly GSE resolution under even acute stress. Our in-depth review of the proposal reinforces our initial assessment: FHFA intends that this proposal and the rules it demands withdraw the “effective” USG guarantee accorded the GSEs in 2008 by the FHFA director when the conservatorships were established that has ever since guided market perception. Not only would Fannie and Freddie have to plan for resolution without a helping hand from U.S. taxpayers, but FHFA now emphatically states also that the GSEs – as is and as they may become – are the only obligor of their debt and MBS. This reinstates the language of the 1992 Act as an operational reality instead of a long-ignored bit of disclosure along the way to *de facto* federal status. Even in proposed form, this statement is a game-changer.

Impact

Congress and the banking agencies have done their utmost since 2008 to ensure that no U.S. bank is too big to fail, with global regulators [recently concluding](#) that the post-crisis framework has largely restored market discipline in this sector. In sharp contrast, the FHFA resolution-planning construct assumes that Fannie and Freddie are TBTF because of mortgage-market concentration and housing-finance systemic impact. FHFA’s goal is thus to ensure that the GSEs in or out of conservatorship are resolved through orderly establishment of a receivership and the bridge “limited-life regulated entity” (LLRE) [required in the 2008 law](#). Unlike even the biggest banks, a troubled GSE would not fail because, FHFA says, that would do too much systemic and macroeconomic damage. However, outstanding obligations would go into a receivership and, from there, be resolved via bankruptcy, not rescue, even as the LLRE keeps the mortgage market’s lights on. Easier said than done, but FHFA now demands that resolution plans ensure this challenging outcome.

As detailed below, the GSEs are to accomplish this feat by, in their resolution planning, assuming no taxpayer bailouts for a receivership, amassing the *ex ante* funding and capital needed to position LLREs for success, and determining ahead of time which core operations could be rapidly divested to whom. As FHFA notes, GSEs are different than banks in that FHFA has no discount window or other emergency authority nor is there a taxpayer-backed, prefunded resource such as the Deposit Insurance Fund to reduce the receivership estate. The agency does not say so, but FHFA is also not bound by the FDIC’s “least-cost” resolution mandate, giving it more flexibility to trim the receivership estate as it deems necessary to maximize LLRE continuity and rapid reprivatization.

FHFA recognizes that balancing all these competing objectives will be hard to pull off, especially now. It thus sets up an iterative resolution-planning process that gives Fannie and Freddie an extended period of time to write their own living wills. The most important first step – and it would need to be taken very quickly after the rule is finalized – is GSE-crafted maps of core business lines and related operations. It is these operations that would live on in new form in the LLREs, leaving pre-resolution assets behind in the receivership for payment under the Bankruptcy Code.

Key features in the proposal address:

- **Core Business Lines:** The most immediate task for the GSEs is to identify core business lines and associated functions so FHFA can determine which go where (i.e., into receivership or the LLRE). Unlike the bank living wills, FHFA's would not require the GSEs also to consider the implications of core business line failure because, FHFA says, core business lines must not fail – were this to be allowed, systemic risk would ensue, it says. Instead of planning for business-line failure, the GSEs must thus identify core business lines for ready transfer to an LLRE. The NPR also does not require the GSEs to identify critical operations on grounds that pretty much everything they do is critical. Only FHFA could change the GSEs' resolution-planning lists after first accepting a GSE's taxonomy, with the agency also seeking comment on whether, given the GSEs' similarities, it should just name core business lines and related activities for resolution-planning purposes.
- **Resolution Plans:** Plans would build on the identifications described above to lay out how each GSE thinks it can continue targeted operations, possibly with some change, in an LLRE. The GSE would also need to detail corporate governance, how the LLRE would be funded, and how it would reach the statutory, five-year deadline for LLRE termination. An array of required and prohibited stress-tested assumptions dictates this planning process. Importantly and as noted, GSEs may not assume taxpayer "extraordinary support" (i.e., no more PSPAs). Fannie and Freddie are also to craft strategic plans stipulating what would go into a receivership how and what ends up in the LLRE; FHFA is not bound by these plans in constructing a receivership, but wants them as guideposts. Interestingly, FHFA treats MI as a "capital-like" instrument for purposes of these strategic plans.
- **Qualified Financial Contracts (QFCs):** The GSEs are parties to systemically-significant QFCs due to their derivatives operations. As recognized after Congress established the systemic [orderly liquidation authority](#) (OLA) in 2010, the Bankruptcy Code is ill-designed for QFCs. As a result, FHFA lays out steps the GSEs are to take to ensure orderly resolution via receivership and LLRE. These must include effective counter-party stays to permit FHFA intervention.
- **Governance:** The NPR includes an array of governance, internal disclosure, reporting, and agency reviews similar in many ways to those required of large banks. Inter-connectivity and account-consolidating mapping is also required.
- **Common Securitization Solution:** Resolution plans must assume its continued operation and dedicate the resources necessary to achieve this or demonstrate that alternative operations would readily substitute for CSS. However, the GSEs need not plan ways to avert CSS's failure, with FHFA noting that the company "may" fall within its resolution authority. More is to come on this important question.
- **Public Reports:** Like those of big banks, GSE resolution plans would be split into public and private sections, with the NPR generally modelling the public sections on those mandated for the biggest banks. FHFA believes that transparency about claims-settlement prioritization in resolution will contribute to greater public understanding that the GSEs are not full-faith-and-credit USG issuers and so it surely would. FHFA also reserves the right to publish information about GSE resolutions, but these reports and even GSE public disclosures may be limited as the GSEs begin to file mandated resolution plans.
- **FHFA Action:** Again reflecting the rule's iterative approach, FHFA plans to go gently into requiring the GSEs to plan for a good night. It will provide only feedback over the first few

resolution cycles and only then get more prescriptive if it thinks the GSEs are up to it. The NPR also sets out a gentle, but enforceable regulatory standard by which resolution-plan credibility will be judged.

Outlook

Although controversial, we doubt the Biden Administration will renounce FHFA's goal which among other things keeps Fannie and Freddie off-budget and thus gives it more fiscal flexibility. FHFA's approach is generally aligned with OLA and it is thus the approach Janet Yellen, the Fed, and other agencies will favor going forward.

Comments on this NPR are due sixty days after *Federal Register* publication. It would take effect fast – Fannie and Freddie might need to get their first lists of core business lines to the agency no later than three months after the rule's effective date. The first resolution plans would then be due eighteen months after the core-business-line filing. However, consistent with the iterative construct described above, FHFA also promises to be merciful if these first lists do not suffice as long as they're a heartfelt try.

As before, FHFA also says it is considering requiring the GSEs to have [total loss-absorbing capacity](#) (TLAC) buffers to provide still greater protection against moral hazard and taxpayer rescue. It will be easier to do so once this resolution framework is place; in its absence, investors would almost surely assume that long-term debt issued to enhance TLAC would be as effectively guaranteed as everything else a GSE issues, wholly mooting TLAC's point.