GSE Activity Report

Friday, January 15, 2021

The Hot Potato and How It Gets Mashed

Summary

Last night, Treasury and FHFA announced an agreement on the GSEs' conservatorship unsatisfactory to all concerned and highly objectionable to many of those on the Hill with the power to change it. However, we doubt the new Congress will be any more able to reform the GSEs than any of the old ones equally determined to do so. And, even if Congress could, it won't anytime soon because of the flood of critical issues and nominations. Absent a catastrophe causing receivership, two things will thus determine the GSEs fate: the outcome of the Supreme Court case and – more immediate and important – FSOC's ability in the near term to declare the GSEs systemic nonbanks and then redefine their role in U.S. housing finance.

Impact

One reason Treasury essentially chickened out of broader reform is fear of market turmoil at this challenging time. This fear was born not only of a lot of Street input directly to Mnuchin, but also of the Fed's fears of market turbulence and its own role. As we previously noted, the Fed has uncertain authority to hold agency paper once the conservatorships end. It was a major agency investor pre-2008 for open-market operations, but that's different than QE and its 2020 market-stabilizing windows. For now, the Fed wants maximum discretion and it thinks it gets it via continued conservatorship, especially with the added influence (see below) it holds.

We will not go through the details of the PSPA revisions since its most important aspects – continued conservatorship, no capital raises until capital compliance, renewed sweeps – are well understood. Less-noticed provisions with strategic impact include:

- The Fed: The new agreement is a role for the Fed in setting the GSEs' commitment fees in return for continued USG support. We have previously noted the importance to Treasury of Fed support for FHFA's capital rule and this is yet more confirmation of the Fed's critical role setting the GSEs' new course, academic though it is for now. This won't satisfy Yellen with regard to systemic designation, but it's acknowledgement of the Fed's still more assertive role in GSE policy and that will make her happier and give her more latitude to tackle other crises before turning to the GSEs.
- GSE Portfolio: It has been widely noted that the new agreement essentially codifies the $250 billion restriction on GSE mortgage holdings. What's less observed is that the portfolio must actually shrink from its current level because mortgage loans must now be measured at par, not by unpaid principal amount. If forbearances turn to foreclosures, this portfolio ceiling could limit the GSEs ability to hold problem loans, forcing faster NPL sales. However, this is yet another provision in the agreement that may need to be revisited by the Biden

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Administration if FHFA either concurs or comes under new leadership should this issue arise.

- Single-Family Mortgages: Consistent with the 2019 Administration plan, these are now curtailed. Most significant are new refi restrictions covering loans with combined high LTVs, DTIs over 45%, and when the borrower has a 680 or less credit score. We expect Brown to go ballistic over the 680 cut-off given his strong focus on racial equity and refis. Investor loans are also sharply curtailed, and (with certain transitions) all purchased loans must be QMs unless subject to limited exceptions. So much for the QM patch no matter what CFPB may come to do about it.
- Multi-Family: This is cut back to no more than $80 billion a year for each GSE, adjusted annually for inflation. Even more interestingly, at least 50% of multi-family purchases must now be mission-driven.
- Capital: It has been widely noted that the GSEs cannot exit conservatorship until they come up to scratch under FHFA's capital rule. Less noticed is a provision that obliges the GSEs to do so regardless of any changes that may be made to the capital rules. This is to some degree a rhetorical flourish since Treasury and FHFA could of course revise their orders to the GSEs if they decide to revise the capital rules, but this agreement would stand even if Congress rewrote the capital rules unless new law also overrode what might be deemed a contractual commitment, not a rule of law subject to Congressional authority.

In terms of industry winners and losers, our initial take is that nonbank originators lose because a wide swath of loans are no longer eligible and bank originators gain new latitude to compete for portfolio investor loans and – to a lesser extent – refis. Servicers may face more challenges if the portfolio limits bite, with reduced deal flow also hitting them hard over time. However, structured financiers do fine since there's still more incentive for the GSEs to figure out some way to do CRTs through the cracks of the capital rule and MIs stand firm since no charter change means no reduction in the charter's credit-enhancement requirement.

Outlook

The new plan again calls for new law, but it also includes more concrete steps to make that happen for the first time. These include a new order to the GSEs to cooperate with Treasury (and to a lesser extent FHFA) figuring out how best to restructure Treasury's investment and dividend amounts to ensure that taxpayers are appropriately compensated for a conservatorship exit. The GSEs are also to work with Treasury and FHFA on questions such as how many guarantors might be needed, with Calabria suggesting last night that the answer might not be the many he earlier postulated, but instead just one.

This plan is to go to Congress by September 30, but of course lots could change before then, with the Supreme Court case clearly the most important intervening event. However, it remains to be seen how dispositive any decision will prove. The Court could confine itself to the question of whether common shareholders have standing and, if they do, then just kick the question of the 2012 PSPA amendments back to the lower courts for still more years of lawyers' fees.

The Court could also choose to opine on Calabria's status, applying to him the at-will dismissal judgment brought to bear last year on the CFPB director. If this were to occur, then Biden would get his own FHFA head; if not, not unless some innovative reading of the law is used to push Calabria out or Congress adopts a short-term statutory change to, as NAR recommended just yesterday, turn FHFA into a commission. This might well happen to FHFA as it's likely to come for the CFPB. But, as with everything in the new Congress, it won't come fast – there's just too much else to do.

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