GSE Activity Report

Friday, January 22, 2021

Can't Live With Them Can't Live Without Them

Summary

The failure of yet another Administration and Congress to conquer the conservatorships does not augur well for constructive policy action anytime soon. However, with so many Obama Administration officials returning to old gigs and, just last week, a new proposal from a powerful advocacy group, we think it more than timely not just to review the utility-model alternative for U.S. mortgage securitization, but also to posit how best to make it work.

Analysis

In this report, we provide a brief background on utility thinking and then outline questions many of these models failed to resolve either from a policy or political perspective. Options in light of recent developments and potential systemic designation are also assessed in order to suggest a refined utility model that may not need new law to become a new reality.

1. Background

FedFin has viewed a utility option as the least-worst way to resolve the GSEs' conservatorships since 2008. In 2016, Treasury Counsellor Weiss resurrected an Obama option considered in 2009 that was then discarded in a 2011 white paper: re-engineering the GSEs into a cooperative along the lines of some longstanding public-service utilities. Along the way, other utility proposals have come from former Democratic officials sure to have considerable impact in Biden thinking and a coalition of housing and banking trade associations. Importantly, utilities are owned by shareholders or even the government; cooperatives are owned by members, making the who's in and who's out decision not only a significant stumbling block for a relatively-seamless transition from the conservatorships without new law, but also a political third rail.

It's for this reason that, the day before Treasury and FHFA made it more than clear that they came up empty on closing the conservatorships, the National Association of Realtors (NAR) put another utility model on the table. Drafted in part by influential private and academic housing experts with Biden ties, the paper – intentionally and sometimes not – highlights inescapable realities that make a utility option increasingly likely. These are: 1) conservatorships are *de facto* utilities to which the market has become accustomed; 2) recapitalization allowing a renewed private model is a long, long way off; 3) the 30-year FRM can't exist without a dedicated, special-purpose charter to guarantee and – less certain – also to securitize it; 4) much in the utility construct can be accomplished under current law; and 5) even if it likes something else better, Congress will be unable to advance comprehensive reform, deferring much of it now to the FSOC.

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2. *Decision Points*

Given the obstacles to Congressional action, a threshold question about the utility option is whether it could be accomplished without new law. The answer is that, while regulatory restructuring into a utility model is viable under current law, FSOC, FHFA, and the Fed would need among them to make tough policy and political decisions on critical questions such as membership, pricing, affordable-housing obligations, and the extent to which an effective guarantee emphasized in official statements suffices for 30-year FRMs in good times and bad. One or more utilities could be made to work, and it might even need to be made to work given the low odds of statutory change, but making it work is no mean feat. A sampling of tough policy and political questions follows. Note that these are summaries of key points, not in-depth analyses of law, rule, market, and market consequence.

- Charter: It's fiendishly complicated to replace existing entities that purchase 30-year FRMs, issue effectively-guaranteed MBS to institutional investors, and, of late, sell CRT positions to the capital market – functions no one else dare to contemplate without structural changes that circle right back to acute political risk. While various proposals in the past sought to arbitrage or obfuscate the implicit guarantee, 2020 events show that even an effective guarantee may not suffice. And, as was clearly evident last year, CRT is highly procyclical and even agency markets can shut down under acute stress. As a result, there will be more appetite than ever before for an explicit guarantee and, since this requires new law, charters able to arbitrage the effective one now in place may well be made to suffice. The new utility might thus be successors to the conservatorships that are either systemically-designated financial companies or – better, we think – systemic financial-market utilities (FMUs). The FMU model is far less capital-intensive than the SIFI construct, but it nonetheless comes under the Fed and might be viable if risk is backed by sterile reserves in the manner now required of banks in the payment system. Notably, FMUs can be stand-alone companies that provide market-utility services or member-owned ventures.
- Structure: There's of course a world of difference between a utility owned by shareholders and utility co-ops owned by members or customers. Trade associations have generally cottoned to the co-op concept because then they would likely control it, but we think Congress will raise a host of objections not only to a single industry-controlled co-op, but also to a series of them that, while smaller, would still be prone to self-interest. Any form of a co-op could also function as a guarantor and/or securitizer of 30-year FRMs only if it has a government backstop, with any and all of these options requiring statutory change of prodigious proportions. In contrast, current law permits converting the GSEs into utilities, barring them from affording control to any investor, implementing an array of prudential changes, and mandating affordable-housing goals. An explicit USG guarantee is outside the reach of regulatory action, but the too-big-to-fail construct of a systemic FMU or SIFI might just do the trick.
- Function: According to the NAR report, private investors now take about 90% of GSE interest-rate risk and 50% of credit risk. The 2019 credit-risk estimate is generous given that it depends on CRT and CRT has now proved itself to be the illiquid backstop we long feared. However, the parameters of these results nonetheless show clearly that, as long as agency MBS and debt are highly liquid, the market can take rate risk, but government must subsidize or absorb credit risk if it wants a simulacrum of Fannie and Freddie. The federal government could enhance credit-risk transfer by converting the GSEs into the equivalent of an FDIC for single-family loan (crowding out MI and CRT), into covered-bond guarantors for portfolio single- and multi-family lenders, and/or splitting credit risk with the capital markets in a CRT 2.0 construct. Each of these options requires careful pricing, a backstop liquidity mechanism for market function under stress (a Ginnie window?), and has widely different private-sector beneficiaries. Each or a combination of all is possible and likely does not require new law given FHFA's broad authority to define the GSEs both in conservatorship and in successor,

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limited-life regulated entity charters. All could also be accomplished in designated SIFI or FMU models under both FHFA and the Fed.

- Market Power: Perhaps the most interesting section of the NAR report challenges conventional wisdom about Fannie and Freddie's market power, calculating the Department of Justice's market-power index (the HHI) to find that the GSEs together fall below the thresholds at which DoJ begins to consider invoking antitrust law. The paper does note that the GSEs' ability to significantly raise g-fees since 2013 without lost marketshare suggests market power not captured by other measures. However, we think that this can only be inferred if one discounts all the other post-2013 factors that took big banks – the only entities that could price-challenge the GSEs – out of the market. It is thoroughly possible that a different GSE business model combined with revised bank rules (e.g., 2019's relaxed MSA standards, the revised standardized approach to risk-based due in 2021) could alter this competitive dynamic.
- Pricing: Utilities are likely to be viewed by investors as more stable than private or even quasi-private ventures, reducing capital costs. This then allows for lower g-fees, reduced LLPAs, and capital retention, assuming investors think the utility is both able to pay regular dividends and keep the mortgage market's lights on under even acute stress. Higher-risk segments might then be served at lower cost than possible under either a fully-private or conservatorship construct.
- Affordable Housing: Left to their own devices, private markets with new power might well price mortgages, especially affordable ones, well above current g-fees. This suggests the need for a mortgage utility that also serves as a ceiling on credit-risk pricing, a function consistent with the options briefly described above. FHA's role as a possible pricing ceiling, affordable window, or counter-cyclical buffer also come very much into play here.
- Leftovers: The analysis above fails to reckon with significant issues, not least the GSEs' major multi-family role. Single- and multi-family finance are so different that a single utility is problematic and a cooperative surely a non-starter since most single-family members have no interest in multi-family and vice versa. The Common Securitization Solution is on its way to spin-off under current policy, but this presumed privatization and of course that is now way off, if ever. Thus, securitization for whom under what pricing needs to be addressed, as does the concept of UMBS if there are more than two utilities.

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