GSE Activity Report

Wednesday, May 5, 2021

Stand by for Shut Down

Summary

Ahead of possible systemic designation for Fannie and Freddie, FHFA is barreling through the systemic rulebook, finalizing capital rules, proposing liquidity standards, and, now, finalizing living-will requirements to ensure orderly GSE resolution under even acute stress. Our in-depth review of the rule reinforces our initial assessment: FHFA is doing its damnedest to withdraw the "effective" USG guarantee accorded the GSEs in 2008 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. Just as like-kind rules for the biggest banks persuaded markets that their implicit guarantee is gone, so too might FHFA begin to crack the TBTF nut for Fannie and Freddie at cost to them and distress to many market participants.

Impact

Congress and the banking agencies have done their utmost since 2010 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. However, Fannie and Freddie have long been outside all the anti-TBTF rules even though, as FHFA observes, mortgage-market concentration and housing-finance systemic impact make them at least as systemic as any of the biggest U.S. banks. The GSEs' exemption of course harkens first to their unique charters and then to the conservatorships, but this agency director is having none of it.

FHFA's avowed 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 2008 law.

On the one hand, FHFA buys into the arguments that GSEs are different. Unlike even the biggest banks, a troubled GSE would not fail because, FHFA says, that would do too much systemic and macroeconomic damage. However, like big banks, FHFA intends that 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.

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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 becomes effective – 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 resolution under the Bankruptcy Code. Commenters pressed FHFA to allow all charter-compliant activities to be considered core and thus transfer, but FHFA refused to do so because doing so would make pretty much all of each GSE bullet-proof from the tough love of a receivership. Core activities will also differ by GSE.

Key features in the rule also 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 rule 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 it.
- Resolution Plans: Plans would build on the identifications described above to lay out how each GSE thinks it can continue targeted operations 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. 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 them when constructing a receivership, but wants them as guideposts. The final rule does, however, reserve FHFA authority to deem some factors immaterial to a resolution plan or otherwise permit tailoring to reduce burden and detail. Interestingly, FHFA treats MI as a "capital-like" instrument for purposes of these strategic plans.
- TBTF: Importantly, GSEs may not assume taxpayer "extraordinary support" (i.e., no more PSPAs). Despite many comments seeking a revision to the proposal to countenance PSPA consideration, drawdown, or revision in resolution planning, FHFA in the final rule says only that the GSEs must consider PSPA requirements as of failure and determine if these are impediments to orderly resolution that must be quelled along with all the others.
- 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. FHFA thus 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 rule 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-consolidation mapping is also required.
- Common Securitization Solution: Resolution plans must assume its continued operation and dedicate the resources necessary to achieve it 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 rule 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 rule also sets out a gentle, but enforceable regulatory standard by which resolution-plan credibility will be judged.

Outlook

The rule is effective on July 6, 2021, with the first resolution plans thus due in the second half of 2023.

Although the Fed could step in and override this resolution rule were the GSEs declared systemic nonbanks as seems likely when FSOC turns to them, this rule was clearly crafted with Fed considerations in mind. However, the final rule also makes it clear that the resolution-planning process is intended solely for the conservatorships, not for when the GSEs are well-capitalized and back to their old charters. It is at this point – perhaps the trigger for systemic designation – that a more express Fed-friendly resolution standard might come into play.

In the meantime, FHFA has more work to do. Up next for orderly resolution: the total loss absorbency capacity (TLAC) rules promised in 2019 when FHFA and the Trump Treasury first set out the path since taken. TLAC without a clear taxpayer backstop will be a very different TLAC than many anticipated when FHFA first broached this idea and a still more expensive proposition.

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