Monday, December 6, 2021

Another Post-Conservatorship Damoclean Sword

Summary

As we noted on Friday, Senate Banking Ranking Member Toomey asked SEC Chairman Gary Gensler a trick question about GSE obligations at the very end of a lengthy letter focused principally on cryptography. Gensler replied that, once Fannie and Freddie leave conservatorship, their status as federal instrumentalities might well end. Were the SEC to think so at the time, trillions in agency investments would be quickly liquidated to conform to regulatory, market, or sovereign investment restrictions.

Impact

In his letter, Toomey points to FHFA's final GSE resolution rule and its clear admonition that shareholders and unsecured creditors should be ready for market discipline -- and thus for loss -- in the event of a GSE receivership. The GSEs are also told by FHFA to abjure any expectation of continued extraordinary support along 2008's lines. Although Toomey doesn't point this out, nothing in the Biden Administration's PSPA rewrite retracts this market-discipline warning.

Based on this exposure to risk, Toomey asked why SEC rules governing MMFs, registration, and other market activity continue to treat agency paper as essentially equivalent to that from the USG itself. Gensler's response is simple: the law says anything equivalent to the USG is an instrumentality of the USG and, as long as the GSEs are in conservatorship, this goes for them regardless of the resolution rule. But, if and when the conservatorships end, this treatment will be reconsidered.

Outlook

There are a lot of ways to parse Gensler's comments, but they -- not to mention Toomey's question -- are an important early warning indicator for possible risks in a receivership and market-structure realignment if the SEC continues this policy at whatever time the conservatorships disappear. Fannie and Freddie of course had agency status pre-2008 due solely to their implicit guarantee and the draft of rules implementing key definitions that then accorded them quasi-sovereign status. In 2008, this assumption of course got a rude -- not to mention costly -- comeuppance. Shareholders were eviscerated and bondholders only saved thanks to the huge sovereign exposures to Fannie and Freddie that, had Paulson at the time disregarded them, would have led to extraordinary contagion risk for Treasury obligations and, thereafter, the global financial system.

Will regulators be willing to take this chance again by continuing the GSEs' quasi-sovereign status when the effective guarantee is retracted? We think this unlikely in a receivership, but also of less than

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catastrophic systemic risk in this scenario. As the resolution rule prescribes, FHFA has broad discretion to move GSE obligations into the GSE equivalent of a bridge corporation and we would expect that all prior bonds and MBS would head there. However, in a receivership, shareholders and unsecured business creditors would be at risk, but this would be considerably less worrisome.

The more interesting question is the impact of the equivalent of de-listing if the GSEs were to exit conservatorship in an orderly fashion and return to their prior charters. When and if this were to happen is of course speculative at best now that Calabria's hopes are dashed and the GSEs have become *de facto* equitable-finance utilities. Renewed privatization zeal or a de jure utility status would confront the de-listing question as a top priority, but the circumstances governing action then are impossible now to forecast.

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