GSE Activity Report

Tuesday, February 21, 2023

Social Studies

Summary

As we noted, FHFA is venturing onto treacherous political ground with a request for input on expanding Fannie and Freddie's ESG imprint. Or, shall we say, their social welfare footprint given that the RFI assiduously differentiates the single-family "social bonds" it proposes from ESG investments. But whatever one calls these new MBS, FHFA clearly intends these to be headed to an investor is near you.

Impact

In the release accompanying the RFI, Sandra Thompson made it clear that she's looking for ways to expand the GSEs' social-bond programs to single family, not whether Fannie and Freddie should do so. The RFI thus describes the GSEs as having both statutory and "other" equity obligations, with the other category incorporating the agency's new, expansive equitable-finance mission. Surely wary of the controversies sparked by ESG investment (see below), FHFA notes that GSE single-family social bonds are not ESG per se, instead falling into the separate category of impact investment – i.e., bonds or other financing dedicated to a single institution or public-welfare purpose.

Regardless of this fine distinction, underlying loans in social bonds would be those that enhance environmental sustainability or affordable home ownership (i.e., by incorporating only loans with features such as downpayment assistance, cost or liquidity subsidies, mandatory counselling, etc.). When issued, these bonds would be accompanied by impact metrics to show their social-welfare mettle at issuance and over time.

The new single-family social-bond program would also build on existing GSE metrics already leading them to designate social index pools, with social bonds intended to expand these efforts into specific instruments that reach a broader market for more innovative social-welfare purposes without threat to borrower privacy.

Although the thrust of the RFI suggests FHFA has already decided to authorize these single-family social bonds, questions cover risks as well as benefits. Some of the more interesting ones include:

- What outcomes should social bonds advance and how could this best be measured? For example, is the liquidity afforded targeted markets sufficient to characterize a social bond or must it advance specific purposes (i.e., for targeted borrowers, products)? Based on desired outcomes, how could results best be measured?

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- What attributes should qualify loans for social bonds? Would these objectives align with investor goals? What disclosures are necessary? How best to ensure borrower privacy as well as investor appeal?

- Should the GSEs make it clear before origination that certain loans would end up in social bonds? The RFI does not describe why this would be done, but it presumably contemplates that lenders would advance targeted loans on more generous terms or create markets for certain products if this were done.

- How best to ensure that social bonds are safe and sound for the GSEs? What market risks might arise, including for UMBS?

- If the GSEs issue social bonds, should they discontinue their affordable and social-index programs?

One issue not addressed in the RFI is the extent to which the GSEs could vary current loan programs to attract loans suitable for social bonds. The product features identified above reflect aspects of the current affordable-loan program, but also could easily encompass new features – e.g., warehouse lines to ensure liquidity, new forms of credit enhancement). Given FHFA's tighter approach to new programs and pilots, we think varying underwriting to redefine eligible purchases would require public disclosure, but we suspect some folks might ask.

Another question not in the RFI – except to the extent inherent in the one on safety and soundness – is how the GSEs' capital standards would affect their ability to issue these bonds. Some forms of collateral may be novel and/or current capital requirements might be prohibitive. Will FHFA allow CRT to absorb these costs? Additional layers of MI? Will capital rules be tweaked to accommodate at least some eligible collateral? Again, all this makes a difference.

Outlook

FHFA as noted goes to considerable lengths to call these bonds "social" and differentiates from them still more controversial "E" environmental bonds. However, social equals the "S" in ESG and thus will surely rile conservatives and Republicans even as its defenders – progressives and Democrats – will counter that Fannie and Freddie are agencies of the government and, especially in conservatorship, bound to serve the public good.

Ordinarily, rhetoric will rage on both sides, with FHFA ultimately able to do what it likes re social bonds because Congress will do nothing about them but talk. These are not, though, ordinary times when it comes to the ESG sector because Republicans have decided to see in it all the evils of stakeholder capitalism and concentrated Wall Street wealth now combined to serve their opponents' agendas. Thus, these social bonds may come in for targeted legislation to prohibit them and FHFA will surely face tough questioning.

In addition to seeking comment by April 17, FHFA is hosting a listening session on March 28. It will surely get an earful. We still think FHFA can and will mandate social bonds, but it will take political licks along the way that may have significant impact on the types of bonds the GSEs ultimately issue.

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