BDA Bond Dealers of America

A Bond Dealers of America Analysis of Federal Policy Impacting the US Fixed Income Markets

FIXED INCOME INSIGHTS

GSE Policy Review

Detailed Political Intelligence, BDA Advocacy, Tangental Activity, Current Status and Outlook

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On September 7, 2008, at the height of the global financial crisis, the Federal Housing Finance Agency (FHFA), the federal government agency that oversees Fannie Mae and Freddie Mac, took control of the two mortgage agencies under conservatorship authority enacted under the Housing and Economic Recovery Act of 2008. The agencies have been operating under conservatorship ever since.

Once deemed a short-term relationship to help smooth the mortgage market, the conservatorship has now entered its 12th year, but some progress has been made to unwind the current relationship. This relationship has been a profitable one for the United States Treasury. According to the Congressional Research Service, Fannie Mae and Freddie Mac have paid the US Treasury more than $292 billion in dividends through 2018 while under conservatorship. In addition, the Temporary Payroll Tax Cut Continuation Act of 2011 (P.L. 112-78) required Fannie and Freddie to raise their guarantee fees by 10 basis points each with the revenue derived from the increase paid to the Treasury Department. Between 2013 and 2018 Fannie and Freddie have paid a combined $16.5 billion to the Treasury under this mandate.

On March 27, 2019, President Trump announced that he had directed relevant federal agencies to develop plans to reform Fannie and Freddie. The reform plan has the goals of recapitalizing Fannie and Freddie, ending conservatorship, improving regulatory oversight over the agencies, promoting competition in the housing finance market, and creating a system that encourages sustainable home ownership and protects taxpayers against bailouts.

BDA Advocacy

Following the Presidential announcement, the BDA Taxable Policy Committee drafted a white paper titled, *BDA Main Street Principles for Reforming GSE*.

The White Paper was produced as an outline for regulators to consult while they work towards GSE reform. While supportive of the overall effort, the BDA stated several key principles that are necessary for a successful reform initiative to ensure the soundness and efficiency of the mortgage finance system.

The BDA principles include:

- Preservation of the “TBA” mortgage securities market
- Uniform MBS (MBS) is a welcomed advancement
- Allow GSE to build, and maintain capital; and
- Preserve local lending models.

While no real legislative progress has been achieved, the FHFA, led by Director Mark Calabria, has taken steps to reform the two mortgage agencies. On June 2, 2020, the agency proposed a capital rule, which is viewed as a crucial first step of reform, and an idea that has been advocated for by the BDA.

Current Proposals

FHSA Enterprise Regulatory Framework

In an initial step from the Trump Administration to roll back Federal ownership of Fannie and Freddie, the FHFA in June 2020, released a proposal that would start the process of rolling back the 2008 emergency actions of development of the conservatorship. The proposal borrows heavily from bank capital rules established under the Basel III regime. If approved, the proposal under its risk-based provisions would require Fannie and Freddie to maintain total capital of not less than eight percent of risk weighted assets, Tier 1 capital of six percent of risk weighted assets, and common equity Tier 1 capital of not less than 4.5 percent of risk weighted assets. Core and Tier 1 capital would be require to be no less than 2.5 percent of adjusted total assets.

The proposal would:

- Require Fannie and Freddie to retain capital equivalent to 4 percent of their assets under normal economic conditions;
- The two companies combined would have to hold a little over $240 billion to support their $6.1 trillion in combined assets; and
- The companies together currently hold about $23.5 billion in capital.

The proposal would require the agencies to calculate capital requirements under standard and advanced approaches and hold capital according to whichever calculation has the larger result. The proposal would establish enforcement procedures for FHFA to oversee and police capital levels and sanctions if capital levels fall behind prescribed levels. In order to avoid restrictions on capital distributions and discretionary bonus payments to employees, the agencies would have to hold a capital conservation buffer in addition to regular capital requirements. The buffer provision could demand even more capital than the minimum requirements.

Finally, the proposal would establish that the agencies can retain profits in order to begin to build capital to levels required under the proposal. Under a "profit sweep" arrangement established under conservatorship, all profits earned by the agencies are effectively required to be paid to the Treasury.

In Late 2019, the BDA drafted a "White Paper" laying out the association's principles for reform. Included in the BDA's paper was the call for "Capital Building."

The BDA stated:

"While it is not inappropriate for the Treasury to earn dividends from the preferred capital it has paid into the GSEs, the "profit sweep" is an impediment to recapitalizing the GSEs and transitioning them from conservatorship. We urge the Treasury to revise the PSPAs to allow the agencies to keep a portion of their net profits, which would become a capital cushion for the companies. Once the GSEs are appropriately recapitalized, some form of privatization or release from conservatorship would be possible. Allowing Fannie Mae and Freddie Mac to retain profits to build capital means a quicker transition from conservatorship. If the reform plans do not materialize and the GSEs remain in conservatorship, Treasury could require the accumulated profit to be transferred to Treasury at that time. "

Treasury Housing Finance Reform

In September of 2019, The US Department of Treasury submitted a document to reform GSE's. The proposal included both administrative and legislative reforms aimed at ending the conservatorship of both Fannie and Freddie. The Department provided over 50 recommendations outlined below.

Legislative Reforms:

- The existing Government support of each GSE under its Senior Preferred Stock Purchase Agreement ("PSPA") with Treasury should be replaced with an explicit, paid-for guarantee backed by the full faith and credit of the Federal Government that is limited to the timely payment of principal and interest on qualifying MBS
- The explicit Government guarantee should be available to the re-chartered GSE and to any other FHFA-approved guarantors of MBS collateralized by eligible conventional mortgage loans or eligible multifamily mortgage loans
- These guarantors would credit enhance the mortgage collateral securing the Government-guaranteed MBS, such that the Federal Government's guarantee would stand behind significant first-loss private capital and would be triggered only in exigent circumstances; and
- The reformed regulatory framework should not create capital arbitrage or other regulatory incentives that bias mortgage lenders toward securitizing their loans through guarantors. In particular, similar credit risks generally

should have similar credit risk capital charges across market participants.

Administrative Reforms:

- Treasury expects that it will be necessary to maintain limited and tailored Government support for the GSE by leaving the PSPA commitment in place after the conservatorships;
- To facilitate recapitalization of the GSE, Treasury and FHFA should consider adjusting the variable dividend (also known as the "net worth sweep") required by the terms of Treasury's senior preferred shares;
- In parallel with recapitalizing the GSE, FHFA should begin the process of ending the GSE' conservatorships; and
- The continuation of limited Government support for the secondary market should not be regarded as a federal preference for mortgage lending through the GSE.

Department of Housing and Urban Development Reform Plan

Working with the Federal Housing Authority(FHA) and the Federal Housing Finance Agency (FHFA), HUD in response to the Presidential Memorandum produced a plan that would roll back the programs risk portfolio while accomplishing a 4 part plan.

This plan includes the main goals of:

- Refocusing the FHA to its Core Mission;
- Protecting American Taxpayer;
- Providing FHA and GNMA the Tools to Appropriately Manage Risk; and
- Providing Liquidity to the Housing Finance System.

Senate Banking Housing Finance Reform

To start the 116th Congress, Senate Banking Chairman Mike Crapo (R-ID) made GSE reform one of his top priorities. In February 2019 he released an outline of goals for housing reform**,** the main priorities include:

- Reduces the systemic, too-big-to-fail risk posed by the current duopoly of mortgage guarantors;
- Preserves existing infrastructure in the housing finance system that works well, while significantly increasing the role of private risk-bearing capital;
- Establishes several new layers of protection between mortgage credit risk and taxpayers;
- Ensures a level playing field for originators of all sizes and types, while also locking in uniform, responsible underwriting standards; and
- Promotes broad accessibility to mortgage credit, including in underserved markets.

This Framework is a compilation of former Senate Banking bills sponsored by Senator Crapo. GSE reform has been a longstanding priority for the Senator.

In 2014, Crapo introduced bipartisan legislation in which Fannie Mae and Freddie Mac would be eliminated and replaced by a new independent agency, the Federal Mortgage Insurance Corporation (FMIC), which would have supervision and examination powers over the loan guarantors and aggregators in the new system. The proposal would set up a securitization platform of FMIC-wrapped mortgage-backed securities (MBS) with an explicit government backstop, but would require private capital to bear a 10% first loss piece.

Think-Tank and Association Positions

- Mortgage Brokers Association: GSE Reform
- Bipartisan Policy Center: Building on the Johnson Crapo Consensus
- Johnson Center-Harvard University: GSE Reform Model
- Center for Responsible Lending: A Framework for Housing Reform
- Urban Institute: GSE Reform is Dead-Long Live GSE Reform!

Market Advocacy

Shortly after the financial crisis and early in the GSEs' conservatorship, there was wide discussion in Washington about winding down and replacing the two mortgage agencies. Alternatives ranged from a government-owned utility to an industry cooperative to authorizing banks to become "mini GSEs." The word "toxic" in reference to the GSEs' standing was often heard in these conversations. Today, that view has all but disappeared. There is not agreement on when or how to move the agencies from conservatorship. There is, however, a nearly universal recognition that they form the cornerstone of the mortgage finance system and must be preserved. In terms of advocacy, much of the impetus for preserving the two agencies initiated with small mortgage originators who were nervous about a wholesale reform of the mortgage liquidity system.

A "Housing Reform Outline" published in early 2019 by Senate Banking Committee Chairman Mike Crapo (R-ID) introduced strategies to maintain the GSEs and general approaches to GSE reform and became the final nail in the "wind down" coffin. Crapo's outline became the basis for the Trump administration's housing reform blueprint with the main difference being that the administration abandoned Crapo's requirement that the legacy GSEs would need to reduce their market share to make room for new entrants. The Trump approach anticipates but does not require that other private mortgage guarantors enter the market.

It is possible but unlikely that Congress could take up the GSE and mortgage reform issue in 2020. The only serious movement we are likely to see on GSE reform in the near term will be initiatives that the administration can undertake on its own without the need for legislation.

Outlook

The window for legislative GSE reform seems to be shutting as we enter the 2020 political season. While the Republican Congress was unable to move substantial reform legislation when they controlled both the House and Senate, some progress was made at the administrative level were proposals were introduced, and not automatically shunned by Democrats.

While at this time it seems reform will remain narrow, most likely with the biggest change being the capital rule, prospects for further action in 2021 seems even less likely. GSE reform in a Biden administration would be a non-priority, while House Financial Services Committee Chairwoman Maxine Waters (D-CA), a long time opponent of reform, will almost certainly retain the position for next Congress.

It's also worth noting that the current financial distress our country is navigating may further delay administrative reform. While the mortgage market has yet to hit severe turbulence, the long-term prospectus on the industry varies.

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