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ARE THE GSES READY TO EXIT FHFA CONSERVATORSHIP?

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The US mortgage market – the epicentre of the 2007-2008 financial crisis – has yet to be reformed.

Nearly half of the USD 10,000 billion in housing loans are guaranteed by the Federal government via two private agencies (GSE), Fannie Mae and Freddie Mac, which were placed under FHFA conservatorship after they were bailed out in 2008.

In recent weeks, there have been growing rumours that the FHFA is seeking to hasten the end of its conservatorship of the two agencies.

Accelerating this process risks restricting household access to mortgage loans by prematurely ending the GSE Patch.

Nonetheless, the colossal amount of capital that would be needed to carry out their exit from conservatorship, as well as uncertainty over the terms for maintaining the government guarantee, are likely to delay this process.

AN INEVITABLE RESCUE

The decisions taken at the height of the 2007-2008 financial crisis made it possible to contain the systemic risks posed by the two private mortgage refinancing giants, Fannie Mae and Freddie Mac. In early September 2008, faced with numerous payment defaults, the two agencies were rescued from bankruptcy by the US Treasury and placed under the conservatorship of a federal agency, the Federal Housing Finance Agency (FHFA). The Treasury subscribed for USD187.5 billion in senior preferred stock from the two agencies, and guaranteed all their obligations[1].

Since then, mortgage-backed securities[2] (MBS) issued by the two big government-sponsored enterprises (GSE) have enjoyed an "effective" guarantee from the Federal government. This guarantee protects investors against all risk of payment defaults on the underlying loans of GSE MBS.

This conservatorship was intended to be temporary. However, twelve years later, none of the legislative proposals to determine their longer-term future or to reform the mortgage market in general have been adopted. As time goes by, the reform projects have converged around the same observation, that government guarantees are essential in ensuring the liquidity and stability of the mortgage market. Recent proposals have argued for a hybrid financing model built around risk sharing between the public and private spheres, depending on whether the risks were deemed to be "extreme" or not[3]. Secondary market liquidity would be supported by an "explicit" government guarantee for securitised loans in return for a commission. At the same time, credit risk transfer programmes developed by the FHFA since 2013 would be more broadly deployed. To ensure market stability, only "non-extreme" risks would be sold to private investors[4].

Everyone seems to agree that the main imperfections suffered by the GSEs prior to the crisis should be stripped away from the new guarantor responsible for structuring the loans: the moral hazard created by the implicit guarantee which the GSE benefited from at no cost; the contradictions between their profitability targets and their public service mission; and the very insufficient level of core capital, especially given their risk exposure. In contrast, there is still ongoing debate over the status of the new guarantors and the future role of Fannie Mae and Freddie Mac within the new system.

The preponderant role played by GSEs in the mortgage market makes any reforms very risky. In 2019, we estimate that Fannie Mae and Freddie Mac had on their balance sheets (in the form of loans or securities backed by loans) or guaranteed nearly USD 4,500 billion in conventional housing loans[5], or 43% of total household mortgage debt (chart 1). This estimate is the sum of:

1/ the stock of MBS issued by Fannie Mae and Freddie Mac and sold to third parties,

2/ the MBS retained by the GSEs (to avoid double counting, cross-holdings are excluded),

3/ the portfolios of loans and securitisations from private issuers purchased by the GSEs for investment purposes.

1Under the Preferred Stock Purchase Agreements (PSPA), the US Treasury agreed to refinance the GSE whenever their net worth became negative. Given the support provided to the two GSE so far, the residual funds total USD 254.1 billion.
2 Securities backed by mortgage loans.
3 The loss rate observed during the 2007-2008 financial crisis could be considered "extreme".
4 For an analysis of the role GSE play in the secondary mortgage market as well as reform proposals and credit risk transfer programmes, see Choulet C., *The fate of Fannie Mae and Freddie Mac is not yet sealed*, Eco Conjoncture, March 2018.
5 Loans originating outside of any Federal programmes.

Credit risks transferred to the private sphere (insurance companies, investors) via insurance policies (Primary Mortgage Insurance, PMI[6]) or structured debt issuances (Credit Risk Transfers, CRT)[7] (chart 2) are then subtracted from the total. Although there is not yet enough data available to update our estimate for the current year, the numbers suggest that the proportion has probably increased. The stress generated by the Covid-19 pandemic has resulted in a new drying up of the private secondary market and has shifted demand towards government-backed securities loans (charts 3 and 4).

IS A RAPID EXIT FROM FHFA CONSERVATORSHIP FEASIBLE?

In recent weeks, there have been growing rumours about an accelerated exit from FHFA conservatorship by the two GSE. Fearing that the new Biden administration might further delay this process, the conservatorship agency is apparently seeking to negotiate with the Secretary of the Treasury for their exit as soon as possible, before Joe Biden enters the White House after his inauguration on 20 January 2021. The President-elect has let it be known that ending the conservatorship is not a priority for the beginning of his term. Yet several obstacles must be cleared before this process can be accelerated.

END OF THE GSE PATCH

The first obstacle pertains to a distortion of competition. Under the Dodd Frank Act of July 2010, originators of mortgage loans are required to ensure that borrowers have the ability to repay their loans[8]. "Qualified mortgages", which meet strict lending criteria, cannot be contested before a court or an agency. Excluded from this category are loans with a maturity of more than 30 years, loans that do not have prudent terms for the payment of principal and interest (negative-amortization, interest-only and balloon-payment loans) and when the debt-to-income ratio exceeds 43% (monthly payment/revenues).

So far, the GSE have benefited from a less demanding derogation system. Once certain criteria have been met (notably in terms of loan features or limits on points and fees), the loans purchased or guaranteed by the two GSE are considered de facto as "qualified mortgages", regardless of the debt-to-income ratio, a measure known as the GSE Patch[9]. On 26 October[10], the Consumer Financial Protection Bureau (CFPB) postponed the expiration of the GSE Patch (initially scheduled for 10 January 2021) to the date when the new definition of "qualifiedmortgages" takes effect (in preparation for the past few months[11]), or when the GSEs exit conservatorship, whichever comes first. Ending the conservatorship of Fannie Mae and Freddie Mac would hasten the expiration of the GSE Patch, and in the absence of a definitive definition of "qualified mortgages", it would risk restricting access to mortgage loans or increasing the cost for nearly a third of borrowers whose debt benefits from a GSE guarantee[12].

FANNIE MAE AND FREDDIE MAC GUARANTEE 43% OF HOUSEHOLD MORTGAGE DEBT

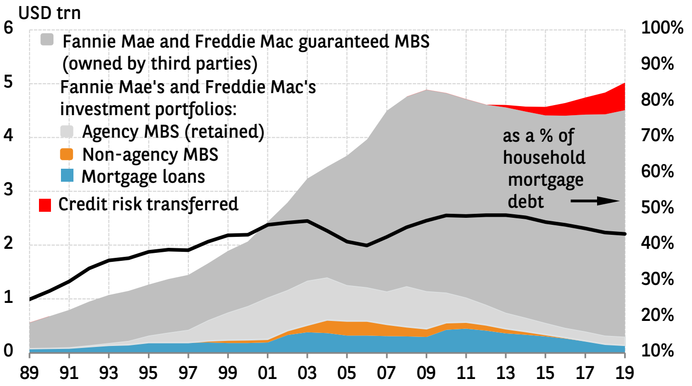

CHART 1 SOURCE: FHFA, FEDERAL RESERVE, BNP PARIBAS CALCULATIONS

FROM 2013 TO 2019, THE GSES HAVE TRANSFERRED USD 500 BN OF CREDIT RISK TO THE MARKET

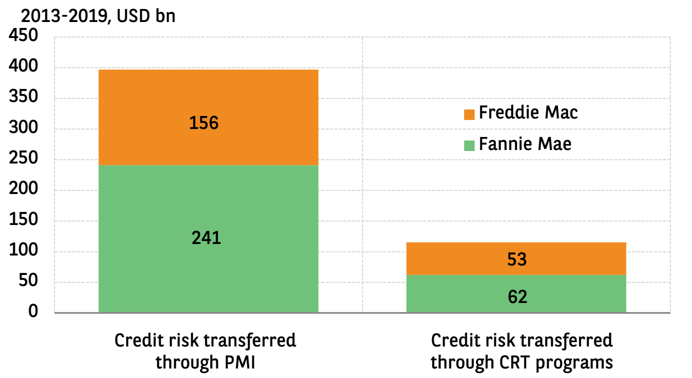

CHART 2 SOURCE: FHFA

6 Borrowers whose down payment is less than 20% of the value of the financed housing must take out a private insurance policy. This type of insurance reduces the exposure of the GSE to credit risk, but it exposes them to high counterparty risk.
7 Structured debt issuances are the main vehicle for risk sharing implemented under the CRT programmes. These securities are unguaranteed, unsecured, floating-rate bonds. Issues are relatively rare but they are backed by relatively large portfolios. These transactions, which are similar to securitisations, do not expose GSEs to any counterparty risk. Any credit loss on the reference portfolio reduces the associated debt outstanding, and thus the amount due to investors.
8 CFPB, Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), Final rule, January 2013,https://www.federalregister.gov/documents/2013/01/30/2013-00736/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z
9 The GSE also impose certain size and quality criteria on the loans they purchase.
10 CFPB, Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): Extension of Sunset Date, Final rule, October 2020, https://www.federalregister.gov/documents/2020/10/26/2020-23540/qualified-mortgage-definition-under-the-truth-in-lending-act-regulation-z-extension-of-sunset-date
11 CFPB would like to replace debt-to-income limits with restrictions on loan's pricing: it would exclude from the definition of "qualified mortgages", any loans with an annual interest rate exceeding the average prime offer rate by 2 percentage points for a comparable operation.
12 Based on data at year-end 2018, CFPB estimates that 16% of residential loans would not have been originated without the GSE Patch (i.e. 31% of the 52% of residential loans held by or guaranteed by GSEs).

A COLOSSAL AMOUNT OF CAPITAL TO RAISE

The second obstacle that must be dealt with is the colossal amount of capital that would have to be injected to exit conservatorship. On 18 November, FHFA finalised the new prudential framework applicable to Fannie Mae and Freddie Mac[13]. This framework calls for the creation of risk-based capital requirements, capital buffers and leverage requirements that are generally comparable to the capital adequacy requirements for banks. Based on balance sheets at 30 June 2020, FHFA estimates the aggregate amount of Common Equity Tier 1 capital required for the two GSEs at USD 207 billion, the aggregate amount of Tier 1 capital at USD 265 billion and the aggregate amount of total regulatory capital at USD 283 billion. The GSE will have to report their capital ratios as of 1 January 2022, but the requirements will not become binding until they have exited FHFA conservatorship, and possibly later if they are granted a consent order. Finalisation of a stronger regulatory capital framework can be seen as a pledge of stability for the mortgage market: it is a key step in the process of reforming the mortgage market and ending the conservatorship of Fannie Mae and Freddie Mac[14].

Although the GSE accumulated heavy losses between 2008 and 2011 (more than USD 250 billion altogether), they have returned to profit since 2012. Yet most of the net worth created has been transferred to the US Treasury in the form of dividends (at least through mid-2019). At 30 September 2020, these dividend payments amounted to a cumulative total of USD 301 billion (chart 5). Since the second half of 2019, Fannie Mae and Freddie Mac have not paid any dividends to the Treasury. Under the modified terms of the Preferred Stock Purchase Agreement (PSPA) reached with the Treasury in September 2019[15], they were able to conserve USD 25 billion and USD 20 billion, respectively, in quarterly net worth created (up from USD 3 billion under the previous PSPA of December 2017), or the full amount created over the past five quarters. This agreement will probably be renewed, which will help the GSE rebuild their core capital base, but a complete recovery will require colossal volumes of capital.

At 30 September, the aggregate book value of equity for the GSE was USD 34.6 billion, but at the same date, they display a negative core capital amount of more than USD 160 billion[16]. The scale of this deficit was not brought up during the finalisation of the regulatory requirement framework for the two GSE. Nonetheless, it will make implementation much more difficult. After taking into account regulatory capital requirements, nearly USD 450 billion in capital will have to be injected to recapitalise Fannie Mae and Freddie Mac. Without calling on the market, this would be equivalent to setting aside 18 years of net aggregated earnings of USD 25 billion (and the suspension of dividend payments to the Treasury).

WHAT ABOUT THE EFFECTIVE GUARANTEE?

The third obstacle pertains to the nature of the government guarantee benefiting GSE securitisations. This "effective" guarantee is conditioned on maintaining Fannie Mae and Freddie Mac under conservatorship.

IN THE FIRST NINE MONTHS OF 2020, ISSUANCE FROM THE GSES ACCOUNTED FOR 71% OF TOTAL RMBS ISSUANCE

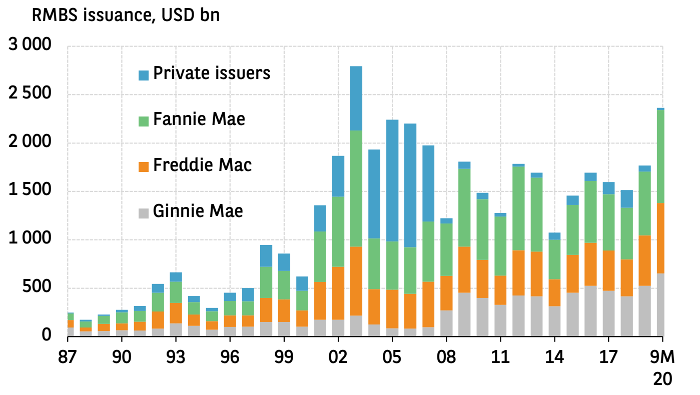

CHART 3 SOURCE: SIFMA, FNMA, FHLMC, GNMA

GSE RMBS REPRESENTED 65% OF RMBS OUTSTANDING AT END-JUNE 2020

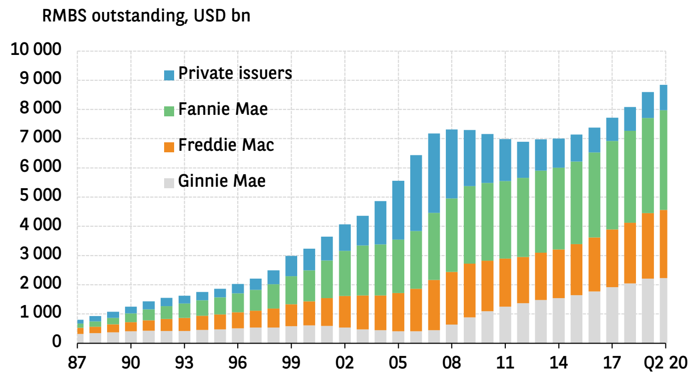

CHART 4 SOURCES : SIFMA, FNMA, FHLMC, GNMA

Without new legislation, once they have exited FHFA conservatorship, the two agencies will no longer be (officially) under the protection of the Treasury and their securitisations will no longer benefit from a government guarantee. Investors in GSE MBS (at least newly issued ones) will no longer be covered against the risks of payment defaults (principal or interest) on the underlying loans. Only Congress is in a position to grant GSE MBS with an explicit "full faith and credit" guarantee from the Federal government, the same as the guarantee granted to Ginnie Mae MBS (the only mortgage refinancing agency wholly-owned by the Federal government).

Accelerating the exit from conservatorship without first defining the legal terms for maintaining the government guarantee on new securitisations and on the stock of previously issued securities would risk

13 FHFA and HUD, Enterprise Regulatory Capital Framework, Final rule, November 2020, https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Final-Capital-Rule-for-the-Enterprises.aspx
14 Before entering conservatorship, the two GSEs were not restricted by very tight leverage standards. Core capital had to cover at least 0.45% of mortgage loans outstanding used as underlying instruments in the GES MBS held by third parties, 0.45% of off-balance sheet commitments, and 2.5% of other balance sheet assets. After entering conservatorship, the GSE were required to report the minimum amount of required capital, even though these requirements were not binding. In September 2020, the deficit in core capital over statutory minimum capital requirements amounted to nearly USD 210 billion (USD 160 billion in negative core capital and USD 50 billion in regulatory capital requirements).
15 https://home.treasury.gov/news/press-releases/sm786
In counterparty, the asset value of the stock of preferred shares in Fannie Mae and Freddie Mac subscribed by the US Treasury should gradually increase by USD 22 billion and USD 17 billion, respectively.
16 In GSE's financial statements, the book value of the stock of preferred shares subscribed by the Treasury is included in equity.

destabilising the financing of the mortgage market. It would also risk undermining investor confidence, which is vital for the successful re-capitalisation of Fannie Mae and Freddie Mac. Lastly, eliminating the effective guarantee that currently benefits GSE MBS would also hit a large number of investors since these securities are commonly used as collateral in the short-term repo markets and they offer an advantageous regulatory treatment[17].

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FANNIE MAE AND FREDDIE MAC: A NEGATIVE CORE CAPITAL OF MORE THAN USD 160 BN

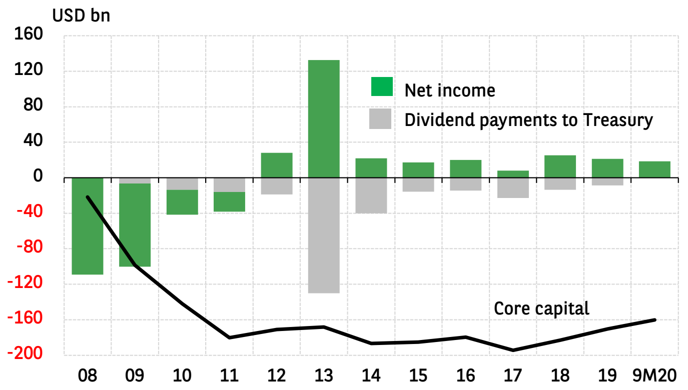

CHART 5

SOURCE : FNMA, FHLMC

17 Under banking regulations, GSE MBS are given a low risk-weighting and recognised as high-quality liquid assets (level 2A) when calculating capital and liquidity ratios.

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