Treasury Releases Housing Reform Plan

- The GSEs (Fannie Mae and Freddie Mac) still remain in conservatorship 10 years following the financial crisis.
- Ultimately, conservatorship is expected to end, subject to certain preconditions.
- Treasury's plan is designed in a way that "preserves what works in the current system, protects taxpayers, and reduces the influence of the Federal Government in the housing finance system."
- Calls for a "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".
- Comprehensive reform requires legislative action but there are many administrative steps that can be taken.
- For example, Treasury is "in the process of negotiating" a plan allowing GSEs to retain more earnings than currently allowed under the net worth sweep.
- Even assuming Congress would act soon (unlikely), this plan likely takes years to come to fruition and there is no guaranty it is enacted in part or whole.

Treasury released their Housing Reform Plan last Thursday (9/5/2019) which puts forth a broad set of suggested legislative actions along with administrative actions Treasury and FHFA can accomplish on their own in the meantime. Treasury's plan seems to be a reasonable balance among proposals considered over the past few years and designed in a way that "preserves what works in the current system, protects taxpayers, and reduces the influence of the Federal Government in the housing finance system." Even though legislative action prior to the 2020 Presidential Election is approximately 0% by this author's estimation, the plan deserves a look by investors given the number of administrative steps that can be taken.

Background

On September 6, 2008, the Federal Housing Finance Authority (FHFA) placed both Fannie Mae and Freddie Mac into conservatorship. The very next day, Treasury entered into the Preferred Stock Purchase Agreement (PSPA) with Fannie and Freddie committing Treasury to invest in each GSE, on an ongoing basis, an amount necessary to maintain positive net worth. Their commitment was first capped at $100 Billion per GSE, then $200 Billion per GSE, and currently sits at $233.7 and $211.8 Billion for Fannie and Freddie, respectively.

In return, along with Treasury's senior preferred shares (initially entitled to a 10% dividend) they received warrants to purchase 80% of the GSE's common stock for a token price along with the right to be paid a "periodic commitment fee". However, neither GSE could generate earnings on a consistent enough basis to make their required dividend payment. Consequently, in a highly controversial 2012 move, Treasury and FHHA amended the shares suspending the commitment fee and replacing the 10% dividend with a net worth sweep where each GSE pays profits above a specified threshold.

Since being placed in conservatorship a decade ago, the GSEs have grown their presence (and influence) in the combined single– and multifamily mortgage space. Some reforms have been enacted like modifying Guarantee Fees (G-Fees), introducing mechanisms to transfer credit risk to investors (rather than tax-payers), and introducing the Common Securitization Platform (CSP) which we wrote about at length in regards to the Single Security Initiative.

What are the goals of the plan?

The plan has three basic goals. First, defining a limited role for the Federal Government. Second, protecting taxpayers against bailouts, and third, promoting competition in the housing finance system. This would involve ending the GSEs conservatorship, recapitalizing them, allowing the potential for more guarantors, and enacting an explicit paid-for guarantee. Some of these require Congressional approval while others can be tackled, at least partly, administratively.

Are you concerned about market disruption?

No, not at the moment. Treasury makes it abundantly clear through their report that they take a careful approach given the potential risks a transition could have on housing related activity.

What does this explicit paid-for guarantee look like?

Effectively, it appears to be a "Ginnie Mae" wrapper on qualifying MBS. According to the plan, part of defining a limited role for the Federal Government means replacing the PSPA commitment with "a 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."

What would happen to my current GSE MBS positions under the proposed plan?

While this isn't explicitly addressed, it seems likely that current positions, or those acquired up to a GSEs potential release, would receive the same treatment in regards to the guarantee.

What would happen to my current GSE Debentures/Debt under the proposed plan?

This is unclear to us at the moment. However, the plan makes it clear that avoiding market disruption takes a place of primary importance. It seems likely to us that current positions, or those acquired up to a GSEs potential release, would be grandfathered in to include existing guarantees, even though it may not be explicitly defined.

Single Family: What struck us as interesting in the plan?

The plan, in the "Clarifying Existing Government Report" section, states under a recommended administrative task that the "FHFA should solicit information on whether to tailor support for cash-out refinancings, investor loans, vacation home loans, higher principal balance loans, or other subsets of GSE-acquired mortgage loans." In short, they ponder the necessity for a government guarantee to be provided, on certain loan types, that might not be consistent with the Federal Government's support of single-family mortgages.

Multifamily: What struck us as interesting in the plan?

It is surprising how much multifamily growth has occurred under broad categories whose balances are not capped. For example, exclusions are granted for "green energy loans" (see Figure 6 in Appendix). Since 2008, GSE ownership or insurance of multifamily debt has increased from 25% to 40% (see Figure 7) and could grow further as the "GSEs have acquired approximately 50% of recent multifamily originations." Treasury recommends, pending legislation, that Treasury and FHFA should "consider amending each PSPA to limit support of each GSE's multifamily business to its underlying affordability mission…". While no specific cap was mentioned, it seems likely under this plan that GSE volumes could reverse growth and likely decline.

What requires legislative action?

Most importantly, Congress would have to authorize a paid-for guarantee by Ginnie Mae of qualifying MBS (both Single– and Multifamily). Yes, you read that correctly, the plan proposes specifically that Ginnie Mae extend their explicit guarantee to MBS backed by the GSEs as well as "any other guarantors that would be chartered by the FHFA." It also requires Congressional approval to authorize the FHFA to charter new, competitor, guarantors to the GSEs. It's worth taking a look at the Appendix to the Treasury Report (starts on page 48 of the PDF) for the complete listing.

What can be accomplished administratively, without legislative action?

Technically, the GSEs can be recapitalized and released without Congressional approval. That seems problematic though without Congressional approval for an explicit guarantee and potential for other guarantors. The most pertinent task, it seems to us at the moment, is recapitalizing the GSEs. This happens to be listed on Treasury's administrative timeline to occur "as promptly as possible". In fact, in a recent interview, Treasury Secretary Mnuchin indicated they are already "in the process of negotiating" a plan allowing GSEs to retain more earnings than currently allowed under the net worth sweep. It's worth taking a look at the Appendix to the Treasury Report (starts on page 48 of the PDF) for the complete listing.

What should I focus on at the moment?

The only thing certain about this plan is that it will change. Right now, given the low probability of legislative action, we think investors' time is best spent focused on potential administrative changes. The most timely of which is how (and how quickly) will the GSEs raise capital? For reference, the GSEs are currently required to maintain a capital cushion *no greater than* ~ $3 Billion, with excess profits being swept to Treasury. If we assume $100 Billion per GSE is a good starting point (Secretary Mnuchin mentioned that figure earlier this week in a Congressional hearing), there is quite a bit of ground to cover. Keep in mind, to date, the GSEs have returned $301 Billion in dividends to Treasury.

This is certain to be a fluid situation and we will provide periodic updates as necessary. In the meantime, if you have any questions, comments, or would like to discuss further, please don't hesitate to reach out to your account representative or directly to me.

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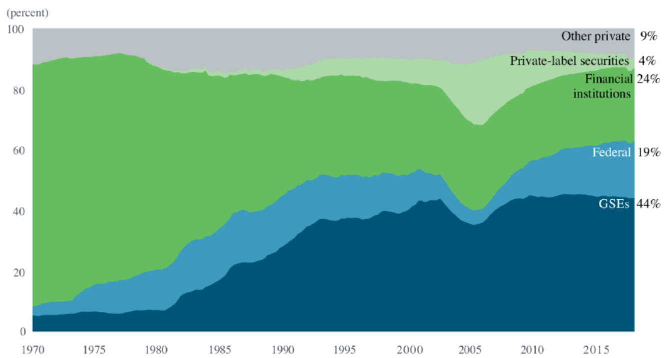
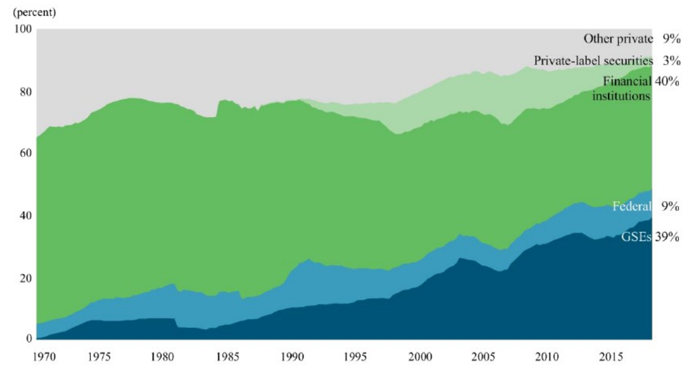
Figure 1. Single-Family Mortgage Debt Outstanding by Mortgage Holder



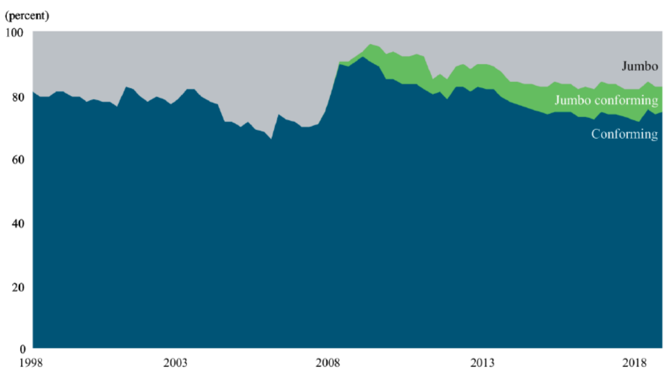
Note: "Other private" includes mortgage debt owned by mortgage companies, REITs, credit unions, individuals, and other entities. "Financial institutions" includes mortgage debt owned by depository institutions and insurance companies. "Federal" includes mortgage debt owned by Ginnie Mae, the FHLBanks, and other federal instrumentalities. Mortgage debt owned by a PLS trust is included in "Private-label securities," even when a GSE owned a portion of the PLS. The holder of mortgage debt is not always the bearer of the underlying credit risk. There have been no adjustments to the data, for example, to reflect financial institutions' ownership of FHA or other Government-insured loans, the GSEs' ownership of PLS, or the GSEs' credit risk transfer transactions.
Source: Federal Reserve, Mortgage Debt Outstanding.

Figure 7. Multifamily Mortgage Debt Outstanding by Mortgage Holder



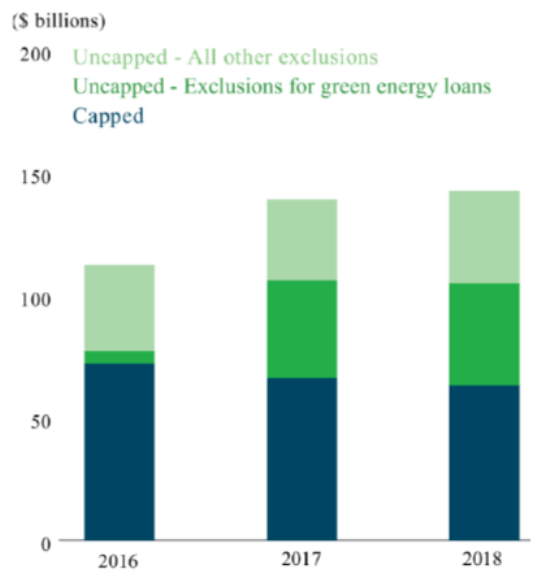
Note: "Other private" includes mortgage debt owned by mortgage companies, REITs, credit unions, individuals, and other entities. "Financial institutions" includes mortgage debt owned by depository institutions and insurance companies. "Federal" includes mortgage debt owned by Ginnie Mae, the FHLBanks, and other federal instrumentalities. Mortgage debt owned by a PLS trust is included in "Private-label securities," even when a GSE owned a portion of the PLS. The holder of mortgage debt is not always the bearer of the underlying credit risk. There have been no adjustments to the data, for example, to reflect financial institutions' ownership of FHA or other Government-insured loans, the GSEs' ownership of PLS, or the GSEs' credit risk transfer transactions.
Source: Federal Reserve, Mortgage Debt Outstanding.

Figure 4. Market Share of Jumbo Mortgage Loans



Note: "Jumbo conforming" means any loan in a high-cost area that has an original principal balance greater than the national baseline conforming loan limit and less than the high-cost area limit for that area.
Source: National Mortgage Database.

Figure 6. Multifamily Acquisitions, Capped and Uncapped



Source: FHFA, 2016-2018 Scorecard Progress Reports.