GSE Activity Report

Monday, June 8, 2020

The Sound of the Screen Door Slamming on the Conservatorship

Summary

In this analysis, we wrap up our series of strategy-focused assessments of FHFA's capital proposal with an analysis of whether it could as intended free the GSEs from conservatorship's yoke in the relatively short near-term. As we have shown, the NPR is complex, model-driven, and laced with questions on alternatives that, if adopted, would lead to widely-different outcomes. And, as we've also noted, externalities – most immediately COVID's macroeconomic impact and eventually the election – affect GSE capitalization and thus the trajectory for structural change. But, even with these caveats, we think it possible that Fannie and Freddie could emerge quickly from conservatorship and, when they do, also emerge in different, but still mighty, form.

Impact

We see three critical factors contributing to a relatively rapid end of the conservatorships under something like the NPR's capital regime:

1) Market Interest

Forecast for the ROE the GSEs could achieve under the new framework hover around the 8% range, leading to suggestions that resulting ROIs will be insufficient to support near-term IPOs. We view this as speculative not only due to the uncertainties described above, but also the unique advantage GSEs have recapitalizing in the wake of a crisis. Clients will recall that ten of the nineteen largest U.S. banks flunked the May, 2009 version of what came to be CCAR, with the banking agencies then setting what seemed to some to be an insuperable bar to capital adequacy. However, by November, nine of the ten banks that had flunked this exercise passed. Thereafter, bank cost of capital didn't fall to the lows expected following subsequent and tougher capital rules and ROEs hovered in the 8-9% range until the last year or so, but banks nonetheless fully recapitalized and then some. The reasons for this are to some extent idiosyncratic to the 2008 crisis, but still instructive in projecting GSE recapitalization.

First, banks in 2009 were seen as wards of the state, beneficiaries of TARP and Fed bailouts that made them too big to fail (TBTF). In a post-crisis period of ultra-low rates and high-risk options, money still had to go somewhere and it thus went to the biggest U.S. banks. The GSEs out of conservatorship will be considered even more TBTF than the biggest banks. For as long as the Fed buys agency MBS – and that seems likely to be a long time – Fannie and Freddie also do not confront the sudden secondary-market shutdown that caused their 2008 conservatorship and both have had also a decade to retool both their cultures and market expectations.

As a result, they will generally be considered impregnable. While it will take time (see below) for the GSEs to promise capital distributions, business-model changes taking advantage of capital-arbitrage opportunities (also see below) will speed recapitalization via investors both averse to risk and eager for long-term value appreciation.

2) FHFA Authority

The NPR makes it very clear that Fannie and Freddie need not be fully recapitalized on the first day the conservatorship ends. As soon as Treasury is willing to spring them, FHFA could deploy the consent decree Calabria has described to create a recapitalization construct in concert with renewed charter authority. Under FHFA's existing prompt corrective action (PCA) construct, Fannie and Freddie can operate even if they are under- or even significantly under-capitalized. These restrictions cover capital distributions, asset growth, new activities, management compensation or others constraints FHFA requires. FHFA could be more or less demanding and/or political in how it exerts this power in freeing Fannie and Freddie, but its scope provides ample authority to allow the GSEs to recapitalize via retained earnings without the need to keep them in conservatorship's thrall while they do so.

Further, even if FHFA does not choose to use a PCA consent decree, the NPR asks for views on a transition period during which the GSEs would come into compliance with the new framework. Nothing in the NPR suggests that the GSEs would need to be out of conservatorship before a transition begins.

We expect a combination of PCA and a transition to be FHFA's likely approach. The NPR references the usual sanction applied in PCA plans in concert with restrictions: a capital remediation schedule. We would note here that changes to bank capital rules are almost always accompanied by transition periods during which companies are exempt from enforcement action as long as they meet interim capital targets.

3) Arbitrage Advantages

According to a recent report, the government now controls 98% of the U.S. single-family mortgage market. This gives Fannie and Freddie enormous pricing power in the sectors in which FHFA chooses to allow them to retain market dominance by virtue of capital advantage. What these sectors are will be clear only after a final rule sets risk weightings and then refines the balance between risk-based and leverage ratios. The future capacity of nonbanks also affects the GSEs' strategy since nonbanks of course must rely on secondary-market channels no matter how they are priced as long as market demand sustains origination volume. Banks of course can pick and choose between portfolio and secondary-market channels, but it would take an enormous amount of new GSE fees to alter the current regulatory balance that tilts in favor of Fannie and Freddie for low-balance, low-risk single-family loans. FHA premium pricing of course affects these equations as does the cost of GSE credit enhancement for HLTV products, but it seems likely that Fannie and Freddie will have considerable scope to price up so they can retain earnings quickly at the outset of a post-COVID recovery that banks may be unwilling or unable to match.

Outlook

That the GSEs can and may well exit conservatorship quickly and that investors will be willing collaborators on rapid recapitalization doesn't mean that Fannie and Freddie then will be what they are now, let alone what they were before 2008. So much is different about the market, so many rules may change for other mortgage players post-COVID, and so much political uncertainty rules as to make impossible any definitive forecast of near-term GSE comparative advantage from so complex a proposal. All we know from the NPR is that there will be some advantage and that it could well be considerable, giving Fannie and Freddie new life as powerful mortgage-market utilities. If investors are at least sort of willing and FHFA uses the powers it has to speed conservatorship's end before a new Administration changes its authority, Fannie and Freddie could take drastic new shape as early as early next year.

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