News From the FAMP Government Affairs Committee

What Lack of GSE Reform Means for Future of Housing Finance

by Victoria Finkle
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WASHINGTON - The dim prospects for a congressional overhaul of the housing finance structure are shifting attention to a host of questions about what the lack of reform means for the future of mortgage lending.

The Senate Banking Committee is poised to hold a markup Thursday on bipartisan legislation that would unwind Fannie Mae and Freddie Mac and replace them with a new mortgage securitization platform and explicit government backstop. Yet the bill is unlikely to move to the chamber floor this year. Meanwhile, a conservative House bill - that would avoid a backstop for the private mortgage market - has stalled.

Those two measures could ultimately be the groundwork for future reform. But it is an open question if lawmakers will resume debate over the government-sponsored

enterprises anytime soon with the same vigor they have displayed over the past year, making the status quo a more likely scenario in the near term. The Senate committee is due for a leadership change
regardless of which party takes control of the chamber after midterm elections, and the 2016 presidential campaign is fast approaching.

We offer three critical takeaways about what the lack of housing finance reform coming from Capitol Hill means for stakeholders over the next several years.

Incremental Changes at FHFA

By far, the clearest result of legislative efforts subsiding will be a renewed focus on the work of the Federal Housing Finance Agency, Fannie and Freddie's conservator now under the direction of former Democratic Rep. Mel Watt.

After keeping his powder dry since taking office in January, Watt made his first major speech on Tuesday when the agency released a new strategic plan. His remarks signaled a shift in the FHFA's objectives away from shrinking Fannie and Freddie to ensuring a robust and stable mortgage market under the current framework.

"FHFA is focused on how we manage the present - the present conservatorships of the enterprises and the present housing finance market under the present statutory mandates," Watt said. Yet, he added, the government's current control of the two GSEs after their 2008 demise "should never be viewed as permanent or as a desirable end state." Watt said "housing finance reform is necessary."

Analysts say there is plenty Watt can do to improve the housing finance system on his own without congressional reforms.

"With legislative efforts stalling on Capitol Hill, it's clear that FHFA will be at the center of the housing universe for the foreseeable future," said Isaac Boltansky, a policy analyst at Compass Point Research & Trading. "After Director Watt's speech you can feel more confident that GSE reform is likely to occur administratively through the FHFA, and therefore will likely be limited in scope and with an elongated timeline."

Watt could even model some of his plans after those proposed in Congress. For example, the Senate bill to be considered in committee on Thursday would likely require a long list of administrative steps by regulators to manage the transition to a new system - steps that Watt could pursue without a mandate from Capitol Hill. (The Senate bill, authored by Banking Committee Chairman Tim Johnson, D-S.D., and top

Republican Mike Crapo of Idaho, builds
on earlier work by Sens. Bob Corker, R-Tenn., and Mark Warner, D-Va.

"While things on the Hill might have stalled, there was always going to be a transition between the bill passing and its going into effect, and there's a lot of that march toward what Johnson-Crapo and Corker-Warner want, and Watt is going to pursue those reforms as the regulator," said Edward Mills, an analyst at FBR Capital Markets. "Maybe at the end of the day, he's going to do 70-80% of the work, and then that transition period can be shortened [in
subsequent legislation] because the transition work has been completed."

Watt could continue FHFA efforts to structure a common securitization platform - and even a common security - for mortgage-related assets backed by Fannie and Freddie. Those advances are similar to components of the Johnson-Crapo bill, which would mandate the creation of a common platform and a single government-backed security by a new regulator, the Federal Mortgage Insurance Corp.

Mills also noted that the FHFA's ongoing work to establish risk-sharing agreements with private companies in some respects parallels Johnson and Crapo's approach. Under their bill, the government would share risk with the market to get more private capital into the system. Private investors would be subject to a 10% first loss requirement.

"More and more, you have the first-loss piece being held by private capital, exactly what Johnson-Crapo wants to do," he said. "So Watt's creating Johnson-Crapo-lite at FHFA."

Adam LaVier, a managing director at Millstein & Co., added that the GSEs will likely attempt to simplify their current risk-sharing efforts as well in an aim to help the private market grow.

"I think Fannie and Freddie voluntarily, or under FHFA encouragement, will eventually commit to one or two standard models for risk sharing in single-family mortgage securities that allow a significant market to develop," he said. "That could take time, maybe five or ten years, but at
the end you could have a fairly deep market in credit risk for the asset class."

Dwindling Capital

Still, even as FHFA forges ahead with changes at the GSEs, the current design of the conservatorships keeps Fannie and Freddie in a somewhat precarious position. The most obvious example of that, observers say, is the two mortgage giants hold just a narrow capital buffer, which by 2018 is set to dwindle down to zero essentially under the Treasury Department's most recent stock purchase agreement.

"The lack of capital is a problem, though as long as the firms are supported by taxpayers, the risk goes to the taxpayers," said Phillip Swagel, a professor at the University of Maryland. "That risk is reduced by risk sharing, but the scale would be much smaller than under the Johnson-Crapo approach."

Recent stress test results for the GSEs found that the mortgage giants could suffer losses of between $80 billion and $90 billion in a downturn, requiring as much as $190 billion in support from Treasury.

"The analog is, when the Fed conducts its stress tests and finds that a bank has inadequate protection against an adverse scenario, the Fed in turn requires that the entity raise more capital," said LaVier. "In the case of Fannie and Freddie, the regulator went through a similar exercise without the change that's demanded on the back end."

Even under less dire circumstances, some in the industry remain worried about what could happen to the GSEs with so few reserves in place. The enterprises have returned to profitability in recent years, but they are required to send that money to Treasury under the stock purchase agreement. Moreover, many have noted that the bulk of those gains can be attributed to short-term accounting charges that are now beginning to dissipate.

Recent earnings reports at the GSEs "really point to the fact that, as operating entities in the normalized environment we're in today, the companies are not the cash cows that everybody made them out to be," said David Stevens, president and chief executive of the Mortgage Bankers Association.

Fannie posted $5.3 billion in profits for the first quarter of 2014 and Freddie Mac earned $4 billion, but net income at both companies was again boosted by big, one-time gains resulting from legal settlements.

In the event of a loss, the companies still have roughly $200 billion in reserves at Treasury that they are authorized to draw on, though access that lifeline would likely face a backlash from lawmakers and some in the industry for accessing that lifeline. If losses continued to mount after those funds are exhausted, it is unclear whether the companies would have to go to Congress to authorize more funding or seek some other course of action.

"Imagine the reaction of Congress if either has to come back for a draw," said Stevens. "These guys have limited backstop from Treasury - the possibility of a harsh congressional reaction raises concerns that we may threaten the stability of the system by not doing reform. We don't want to end up doing GSE reform in a crisis."

Ongoing Uncertainty

More broadly, leaving the status quo in place would continue a pervasive sense of uncertainty in the financial services industry surrounding the housing finance system.

The conservatorships were intended to serve as a "time out" for the GSEs, but have instead put the market, the mortgage giants and their employees in a perpetual state of limbo.

"There are worries about the firms themselves. They have lots of great people, but with the uncertainty, you could imagine some leaving and the firms hesitating to make investments in their systems," said Swagel.

Still, others offered a somewhat more optimistic assessment. They said the medium-term outlook is actually somewhat more settled now that Watt is installed and starting to move forward with his own plans.

"Since there is now a permanent director at FHFA who has been confirmed by the Senate, and any transition to a new system is going to take five or more years to be enacted, that signals to employees at Fannie and Freddie and the FHFA that they can stick around for a while and there's no immediate threat to their positions," said Mills.

In fact, the near term may be even clearer now that the expectations for legislative reform over the next couple of years have fallen.

"Brain drain is a challenge. But it is easier to manage under the assumption of perpetual or at least long-term conservatorship with clear goals than with legislation that decrees one or more cliffs in the firms in the medium term," LaVier said.