US Rates Watch

GSE change in the air

Bank of America Merrill Lynch

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Markets are pricing potential for change

Increased potential for ending the Fannie and Freddie conservatorships is reflected in the recent price appreciation of GSE common equity and junior preferreds. The debt markets have not responded, however, and we agree that ending the conservatorship would likely not impact debt spreads. Because Congress is unlikely to pass GSE legislation, the main issue for investors is to what extent the FHFA acting alone (Federal Housing Finance Authority, the government agency that regulates Fannie, Freddie and Federal Home Loan Banks) or in coordination with the Treasury department can make material changes to the existing government backstop, the conservatorship, the coupon payments on junior preferreds, etc.

Big changes do not require Congress

The government backstop of Fannie/Freddie takes the form of a Preferred Stock Purchase Agreement (PSPA), which is an agreement between Treasury and FHFA – not involving Congress – that ensures capital solvency of the GSEs in exchange for compensation to the government in the form of preferred share coupon payments. Fannie Mae has $114bn remaining under this agreement and Freddie has $140bn. This government guarantee of GSE solvency is unlimited in time but limited by the $254bn total, which cannot be increased without Congress and is large relative to the $187bn injected in the years following the 2008 housing crisis. Fannie/Freddie have paid $286bn in dividends back to the Treasury on the $187bn investment. The PSPAs have been changed 4 times since 2008 by mutual agreement between FHFA and Treasury, which Treasury has written is the only way to change the PSPAs, with the latest change occurring December 2017.

FHFA can end conservatorships by consent of Treasury

The PSPA states that the FHFA can end the conservatorship with consent of the Treasury. But because the FHFA's overall priority is to promote safety and soundness of the GSEs and housing finance markets, any decision about changes to the conservatorship we think would be designed to not disrupt markets. Any plan would likely seek a multi-year transition, possibly relying on a capital threshold for ending the conservatorships in the future. While it is feasible to end the conservatorships immediately, we think this carries a higher risk of market disruption, only because markets would have less time to fully digest the consequences and implications.

Govt backstop continues after conservatorship

A crucial point is that the $254bn backstop is not contingent on conservatorship status. The backstop can remain if the conservatorships are ended or if the GSEs are put into receivership, which is a liquidation process equivalent to bank receivership. While GSE liabilities benefit from a market-assumed implied government guarantee that does not formally exist, they also benefit from these solvency backstops, and we believe that any plan to end conservatorships and privatize or wind down pieces of the GSEs would entail continuation of the entire backstop amounts with some modifications, such as reduced coupons on the senior preferreds, a quarterly commitment fee to pay for the backstop in perpetuity, and potentially an allowance for resumed coupons on junior preferreds once capital levels are above a threshold.

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FHFA and Treasury cannot guarantee GSE liabilities

Fannie/Freddie corporate debt and MBS carry no explicit government guarantee, but do benefit from an implied government guarantee that stems from their government corporate charters, their footprint in the US economy (the combined Fannie/Freddie balance sheet is 26% of US GDP) and their special status in US regulations: eligibility for government-only money market funds, 20% risk-weighting in bank capital rules, and eligibility for purchase by the Federal Reserve. But Fannie/Freddie are completely private insurance companies and are not government agencies. To provide a true full faith and credit guarantee to their debt securities would require an act of Congress, as it would create a new taxpayer liability. Because of divided politics on this issue, this has not happened and we do not expect it to happen under the current administration.

Potential scenario: raise capital, end conservatorships

Because the status quo is currently functioning well, and change always entails risk, we have to put a high probability on nothing happening with the GSEs during this administration or future administrations. Given Director Otting's remarks last week, however, we do expect a plan to emerge from the Treasury department within the next few months. We expect the plan to focus on 3 main pillars expressed by Secretary Mnuchin in 2016:

1. Ensure the continued availability of 30-year fixed prepayable mortgages;
2. End government control of Fannie and Freddie;
3. Minimize risk to taxpayers of future bailouts.

This, in our view, translates into a plan to re-capitalize the GSEs over a period of several years by retaining earnings (while senior preferred coupons are suspended) and raising new capital. When a capital threshold is reached, somewhere in the neighborhood of a 2.5%-3% leverage ratio, the conservatorship would end. We expect the $254bn backstop to remain in place throughout the capital-build phase, but after conservatorship ends, there would likely be a plan to partially wind this commitment down or to sell it to private insurers. Keeping a portion in place would add a layer of safety above and beyond the private capital raised during the recap and would be paid for via a fee structure outlined in the modified PSPA.

Markets need not be disrupted

Fannie and Freddie operations and market functioning would not change, and debt spreads we think would be little impacted, but there is some scope for moderate widening depending on the exact details and timing of the plan, assuming the market trades a non-zero probability of it being executed. We would not expect any changes to the special status of GSE debt and MBS in regulatory treatments or money markets, because the GSE status (government charters) would not change in an FHFA-Treasury led plan.

None of this would preclude actions by a future Congress to fully nationalize the GSEs or go the other direction and remove their government charters and GSE status (a complete of privatization). Such Congressional action we view as very unlikely.

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