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What's Next: Housing Finance

October 1, 2019

OUR VIEW	The most likely path forward on housing finance looks to be a modified and reformed version of 'recap and release.' Through administrative actions, we expect to see Fannie Mae and Freddie Mac eventually released from conservatorship as private entities with capital in a first-loss position and a modified, contractual guarantee through the PSPAs. In exchange for this limited and tailored government support, the GSEs will continue to pay a periodic commitment fee to Treasury while also having their footprint and scope substantially reduced through PSPA amendments. We believe FHFA, Treasury, and CFPB will continue moving forward with administrative reforms through 2019 as Congress considers legislation. However, given the policy complexities, shrinking legislative calendar, and absence of a legislative product from the Senate Banking Committee so far, we believe that momentum and attention will fully shift from legislative to administrative reforms by end of year. Treasury and FHFA have already demonstrated their commitment to administrative reform as they moved quickly to enter into a letter agreement yesterday to allow the GSEs to retain earnings and start the recapitalization process. We expect the next major administrative action from CFPB will be to issue a NPRM on the QM patch and for FHFA to advance its enterprise capital rule. We still expect a multi-year trajectory extending beyond the 2020 presidential election to fully execute this modified recap and release plan.
WHAT YOU SHOULD KNOW **"the recommendations should be viewed as a comprehensive "wish list" from Treasury and HUD rather than a specific sequence of action items"**	Here are the most important developments in GSE reform since our last State of Play: **Treasury and HUD Reports Released** • These highly anticipated reports were released on September 5th and began administrative reforms in earnest, most notably the negotiation of the PSPAs. This is a key milestone in that it started the clock for Congress to propose a legislative solution to GSE reform and strongly signaled future administrative actions. • The reports were generally in line with most policy expectations and recent comments by key officials, but light on important details such as the total amount of capital reserves needed at the GSEs and the timing for reform. The reports provide nearly 100 legislative and administrative actions, so the recommendations should be viewed as a comprehensive "wish list" from Treasury and HUD rather than a specific sequence of action items. • Notably, Sen. Sherrod Brown (D-OH) and Rep. Maxine Waters (D-CA) criticized the plans for proposing to eliminate the affordable housing goals and duty-to-serve requirements for the GSEs. They also argued that the proposed reforms would harm consumers by making mortgages more expensive and harder to get.

	Senate Banking Committee Hearing
	• The Senate Banking Committee (SBC) had Treasury Secretary Steven Mnuchin, HUD Secretary Ben Carson, and FHFA Director Mark Calabria testify on September 10th, a week after the Treasury and HUD reports were released. • The most important takeaway from the hearing was that it laid bare the stark policy differences between Senate Republicans and Democrats on housing finance reform. For example, Ranking Member Brown ended the hearing by asking about a utility model for the GSEs – this indicates that the committee is far from reaching a bipartisan consensus on what legislation should look like. • Any serious legislative product will likely come from Senators Crapo and moderate Democrats in SBC and must be bipartisan to make it through House Financial Services Committee (HFSC) Chairwoman Waters, a Democratic House, and ultimately to the president's desk.
"we believe it is unlikely that Senator Crapo and Democrats will reach an agreement and introduce comprehensive and bipartisan housing finance reform legislation"	• Given the lack of consensus in SBC and our expectation that momentum will shift to administrative reforms by end of year, we believe it is unlikely that Senator Crapo and Democrats will reach an agreement and introduce comprehensive and bipartisan housing finance reform legislation. This would mean that there can neither be newly chartered guarantors nor an explicit, paid-for government guarantee of mortgage-backed securities. • We will continue to monitor whether Congress reengages in 2020 to provide an explicit, paid-for government guarantee of MBS through legislation. Our view is that this debate only occurs in a serious manner if markets react negatively to privatized GSEs operating without an explicit guarantee.
	Expected House Financial Services Committee Activity
	• Mnuchin, Carson, and Calabria are expected to testify in front of the HFSC, potentially the week of October 21st. We expect the debate to be even more polarized than in the SBC hearing, with a particular focus from House Democrats like Chairwoman Waters on affordable housing and how the proposed reforms would likely increase the cost of mortgage credit for consumers.
WHAT'S NEXT	**Action: End the net-worth sweep, revise the PSPAs, and begin recapitalization**
"We still expect future amendments to deal with a longer-term commitment fee and structural reforms built into the PSPA."	• Treasury and FHFA are actively negotiating amendments to the PSPAs and aiming to end the net-worth sweep imminently. They announced yesterday that they agreed to modify the PSPAs to allow Fannie and Freddie to retain additional earnings beyond the $3 billion capital buffer currently allowed for each. This starts the multi-year capitalization process and will allow Fannie and Freddie to retain up to a combined $45 billion in earnings ($25 and $20 billion, respectively). Estimates of the total combined amount of capital reserves needed at the GSEs range from $100-250 billion. We still expect future amendments to deal with a longer-term commitment fee and structural reforms built into the PSPA. • Calabria is considering taking Fannie and Freddie public as soon as May 2020, though we believe it is a multi-year effort. If successful, this would easily be the largest IPO in history, dwarfing Alibaba's $25 billion public offering in 2014. There are several preparatory steps needed before a capital raise, including amending the PSPAs, deciding on a periodic commitment fee to Treasury, and finalizing FHFA's capital rule and CFPB's QM rule.
"the government's implicit support of the GSEs is not going anywhere"	• Notably, the Treasury report calls for an amended PSPA commitment to remain in place even after conservatorship ends, rather than eliminating it. We interpret this to mean that the government's implicit support of the GSEs is not going anywhere, especially if legislative reforms are not successful. Instead, taxpayer exposure will be reduced primarily by putting private capital in a first-loss

position and charging the GSEs a periodic commitment fee so that Treasury's ongoing commitment under each PSPA could be drawn upon only in "exigent circumstances."

"we view the implicit guarantee to effectively be conditional"

- For those hoping for the government's role in the mortgage markets to be drastically reduced, this is hardly a brave new world for the GSEs. However, we view the implicit guarantee to effectively be conditional – this means that in exchange for the government's continued support for Fannie and Freddie, their footprint will be substantially shrunken in order to level the playing field between the GSEs and private-label securitization.
- Target date: Ongoing to end-of-year

Action: Finalize or re-propose FHFA's capital rule

- FHFA will either be finalizing its enterprise capital requirements or re-proposing it as an NPRM. The final rule would go into effect once Fannie and Freddie are released from conservatorship, meaning that completing the rulemaking will be necessary before conservatorship ends and the GSEs go public.
- It is unclear whether the rule will be finalized or re-proposed. FHFA risks a legal challenge if it finalizes a rule that is substantially different from the initial proposal. Moving forward on this rulemaking is a key piece of reform because it sets the target amount for recapitalization.

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- Key questions remain around what the shift toward private capital means for the credit standing of Fannie and Freddie, especially if an implicit guarantee and amended PSPA commitment remain in place after conservatorship ends. We believe it is possible that this could affect Fannie and Freddie's ability to attract public through the public markets.
- Target date: December (if finalized), May 2020 (if re-proposed)

Action: Advance the CFPB QM rule

- The Bureau issued its ANPR on July 25th and took an aggressive step in calling for the GSE patch to expire on January 2021 or possibly after a short extension of 6-12 months, rather than creating an interim or transitional patch. The ANPR considers whether and how to revise Regulation Z's QM definition, such as the use of debt-to-income (DTI) in evaluating a borrower's ability-to-repay, the 43% DTI threshold, and revising or removing Appendix Q.
- The Treasury report echoes the ANPR in supporting the expiration of the QM patch and recommends a new, bright-line safe harbor after the patch expires available to all qualifying loans regardless of GSE eligibility.

"Changing the patch remains the biggest administrative tool to shrink Fannie and Freddie's portfolio and footprint in the market"

- Changing the patch remains the biggest administrative tool to shrink Fannie and Freddie's portfolio and footprint in the market – this rulemaking will be a key part of the "conditional guarantee" we describe above. However, as this is an Advanced Notice of Proposed Rulemaking instead of a Notice of Proposed Rulemaking, the Bureau has a longer runway to operate and more latitude to change direction based on public comments received.
- Target date: NPRM is likely to be issued next year after the comment period ends. A final rule is likely by May 2020 to avoid being overturned in the future through the Congressional Review Act.