Housing Reform 2017: Can the GSEs be Privatized?

Back in April of 2016, Kroll Bond Rating Agency (KBRA) published a research note, **Is there Any New Thinking on Housing Finance Reform?**, which was in response to a paper entitled "A More Promising Road to GSE Reform." Our conclusion at the time was that there was nothing particularly new in prospect for housing finance reform. That judgement has not changed since last year, this despite the November election and some hopeful statements from a cabinet nominee. Below we review some of the recent developments in the housing sector and, in particular, discuss some key issues involved with changing the current status of the government sponsored enterprises (GSEs).

Treasury Secretary designate Steven Mnuchin has opined that the GSEs, Fannie Mae and Freddie Mac, should be privatized. In an interview last November with Commerce Secretary designate Wilbur Ross and Maria Bartiromo on "FoxBusiness", Mnuchin said that the government-sponsored enterprises will be taken out of "government ownership," restructured, and privatized rather than liquidated, as proposed by House Finance Services Chairman Jeb Hensarling, R-TX. The comments by Mnuchin suggest that somehow public ownership of the GSEs is preventing mortgage lending, when precisely the opposite is the case. For example:

- The GSEs provide a substantial subsidy to the housing finance market first by using the superior credit standing of the U.S. government to support the sale of securities secured by 1-4 family home loans. The USA is unique (save tiny Denmark) in offering 30-year, fixed rate, fully amortizing callable mortgage loans to homeowners.

- The GSEs also act as guarantor for these mortgage securities, taking the first-loss credit risk on the underlying loans. By guaranteeing the credit risk, the GSEs make it easier for the bond market to deal with the long and variable duration risk of a 30-year mortgage.

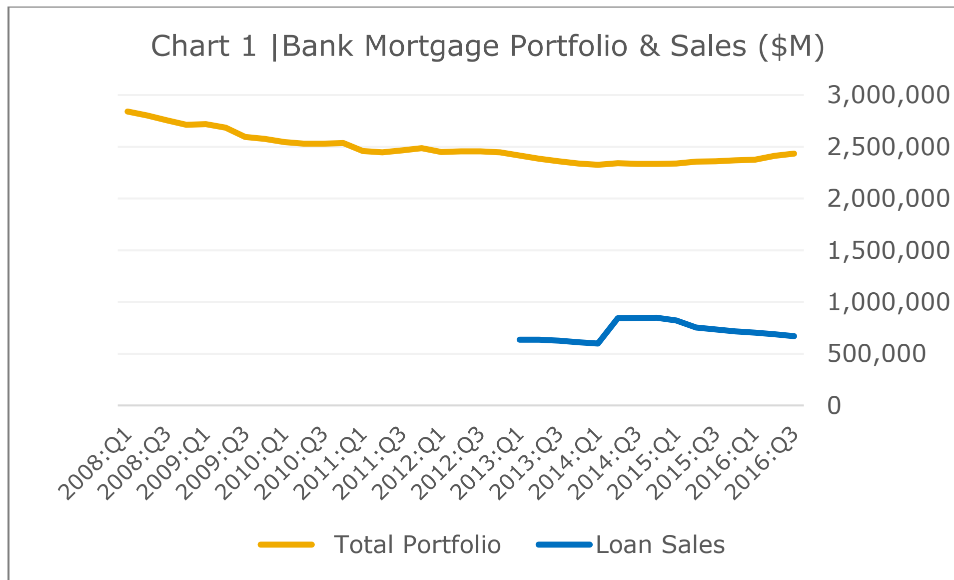
- Finally, the implicit governmental guarantee for the securities issued by the GSEs makes possible a forward, "to be announced" (TBA), market that allows for the efficient management of interest rate risk. Mortgage lenders are able to hedge their interest rate risk against a homogenous and fungible agency security in the future, usually 30-60 days forward. The TBA market greatly reduces the interest rate risk for lenders and cuts the cost of mortgage loans for consumers.

KBRA is concerned that many participants in the discussion regarding housing finance reform do not understand that without some degree of governmental support, the market for 30-year mortgages would change dramatically and, in particular, the TBA market would cease to exist.

The governmental backing for GSE securities is essential for the operation of the TBA market, which is one of the largest securities markets in the world after the market for U.S. Treasury debt. Rosner (2015), for example, has suggested that the GSEs pay an annual commitment fee to the Treasury in place of the existing Treasury credit line, but ultimately the Treasury backstop is the wellspring of the "implicit support" for both entities and supports investment in GSE securities and the TBA market.[1]

Today, commercial banks account for just half of the $10 trillion US mortgage market while non-banks account for the rest of the annual production of new loans. With no forward TBA market to hedge interest rate risk, non-banks would be marginalized and only commercial banks could hold 1-4 family mortgages, either for portfolio or sale. Banks would see a substantial increase in cost. Banks today only hold about $2.5 trillion in 1-4 family mortgage loans in portfolio and have been selling roughly a like but declining amount (~ $600 billion per quarter) of loans into the GSE and FHA markets in recent years, as shown in Chart 1 on the following page.

[1] Rosner, Josh, "The Future of the U.S. Housing Finance System, Graham," Fisher & Co. (2015)



Source: FDIC

While privatization may seem desirable in terms of protecting taxpayers, the functional reality is that the GSEs today perform functions that the private markets are unwilling to provide, at least at current levels of mortgage interest rates and equity returns. As mentioned above, the GSEs take market and credit risk that private investors have so far been unwilling to bear. With respect to the credit risk, today there is no significant market for taking first loss risk on single family mortgages other than prime loans held in portfolio on the balance sheets of depository institutions.

At higher rates of return and without the competition from the GSEs in the bond market, however, KBRA believes that a private mortgage market could develop over time, as we discussed recently on **"Marketplace"**. But we respectfully submit that all participants in this discussion need to appreciate that the reasons why experienced mortgage firms have been unable to restart the market for private-label securitizations (PLS) in earnest: 1) better execution for non-conforming loans into bank portfolios, 2) high cost of insuring first loss risk in the bond market and 3) the superior bond market execution of the GSEs. No private issuer can compete with a GSE in terms of funding costs and bond market execution.

But assuming that the GSEs were removed as competitors to private issuers, there are some additional reasons of similar or even greater effect that currently block the return of a private mortgage market, including:

- The increased regulatory burden on PLS participants and their correspondent lenders, to comply with qualified mortgage (QM)/ability to repay, and TILA-RESPA Integrated Disclosure (TRID), far-reaching consumer protection laws which are disproportionately applied to non-agency lending versus agency lending. Today the GSEs enjoy a wholesale exemption from debt-to-income requirements for QM safe harbor protection until 2021. Also, the GSEs offer substantially more lenient TRID requirements and reviews than are required for PLS.

- Lack of interest at current prices for placement of senior bonds on PLS (primarily super-prime) due to relative value and yield considerations driven by secondary market liquidity issues.

- Hesitance for larger institutions, still, to become active again in the much maligned market for residential mortgage backed securities (RMBS) – even with significant structural changes and higher returns.

Liquidity vs. Capital

With respect to the credit standing of the GSEs as issuers of securities and counterparties, the issue of sovereign support is even more complex. The question here is not capital, as many advocates of privatization argue, but the intangible investor confidence that comes with the full support of a AAA rated sovereign. Even were the GSEs to raise sufficient capital to fully cover the residual credit risk that comes from issuing RMBS, a number which is admittedly small looking at historical and current default rates on 1-4 family collateral, fully privatized GSEs would not have the same credit standing as they do today under government control.[2]

Just as the question of bank safety and soundness involves liquidity rather than capital, so too would fully private GSEs simply be very large non-bank mortgage firms. Again, KBRA reminds all concerned with the issue of housing finance reform that the GSEs failed because of a loss of confidence and market liquidity, not inadequate capital. Without the backing of the Treasury, the liquidity risk profile of a GSE would be little different than that of any other large, non-bank mortgage firm. Former Treasury Secretary Henry "Hank" Paulson **noted in January 2009** with respect to the issue of privatization:

> "I am skeptical that the 'break it up and privatize it' option will prove to be a robust or even viable model of any substantial scale, without some sort of government support or protection. It is difficult to envision a sound, practical, private sector mortgage insurance business of any significant size that does not require large amounts of capital, and consequently generates only a modest return on capital."

The real question that must be answered in any rational discussion of privatizing the GSEs is this: privatized into what? If these firms act as low-risk conduits for mortgage issuance, then their capital needs will be relatively small and there may be some way to create a market for private-label loans and securities. But if these firms take substantial balance sheet risk by holding loans and securities, issuing guarantees and purchasing mortgage-servicing rights (MSRs), then we have a hard time seeing how these firms would differ substantially from existing non-bank firms. As Paulson suggested, these firms will have the same single-digit equity returns as in evidence from non-bank mortgage firms and banks today.

Key Obstacles: The End of TBA and Growth of Ginnie Mae

In the absence of the GSEs, KBRA believes that investors would be willing to take both the credit and market risk on 1-4 family loans, but likely at yield levels several points above the current government-supported market. Although the coupon of a theoretical private mortgage loan itself might not be significantly higher than current agency coupons, the lack of a TBA market that full GSE privatization implies would significantly raise the overall cost of the loan, especially for non-bank mortgage lenders that lack the internal deposit funding of a commercial bank.

Assuming the full privatization of the GSEs and the elimination of the TBA market, the fact of the continued existence of the Federal Housing Administration (FHA) and Ginnie Mae (GNMA) also would likely thwart attempts to create a meaningful private market for mortgage loans. Ginnie Mae is already on track to reach $2 trillion in total outstanding 1-4 family mortgage bond issuance by the middle of 2017. Any effort to privatize the GSEs would also require robust limits on FHA loan guarantees to focus the agency on its traditional mission of serving lower income borrowers.

[2] Whalen, Christopher, **"How Much Capital Does a GSE Need?"**, *American Banker*, September 19, 2014

While the discussion of privatization of the GSEs continues, there are significant changes occurring in the market for government guaranteed loans. The long-awaited change made to the acknowledgement agreement by Ginnie Mae just before Christmas will give lenders and investors greater comfort regarding their rights in the event of default by a servicer in the FHA market. KBRA believes that the amendment announced by Ginnie Mae President Ted Tozer will accelerate the growth of the FHA market at the expense of both GSEs.[3] Unlike the "implicit" support for the GSEs, however, Ginnie Mae has the explicit backing from the US Treasury, a fact which makes the agency's paper attractive to foreign central banks.

Until now, market participants never had explicit confirmation as to how GNMA would behave in the event of a servicer default. The Ginnie Mae documentation didn't give any comfort that this is how defaults would play out in reality. KBRA believes that the change to the Ginnie Mae acknowledgement agreement is not just a significant development for warehouse lending, but also has a huge impact on GNMA MSR and servicing advance lending. We believe that the new acknowledgment agreement will help bring more liquidity to GNMA products and put the GSEs at a competitive disadvantage. Indeed, in the wake of the change, spreads on GNMA collateral have already tightened.

Conclusion

The Mortgage Bankers Association sends a very clear message about privatizing the GSEs: It will raise rates for homeowners and add systemic risk back into the financial system. Why do we need to fix a proven market mechanism that is not broken? KBRA believes that if Mr. Mnuchin and the President-elect truly want to encourage the growth of a private market for U.S. mortgages, then they must accept that true privatization of the GSEs that eliminates any government guarantee would fundamentally change the mortgage market.

The privatization of the GSEs implies, in the short term at least, a significant decrease in the financing available to the U.S. housing market. In the absence of a TBA market, no coupon would be high enough to support the entire range of demand for mortgage finance, only pockets of higher quality loans as with the jumbo mortgage market today. Unless the U.S. moved to the Danish model with 100% variable rate notes, no nonbank could fund the production of home mortgages efficiently and commercial banks are unlikely to pick up the slack for the reasons discussed above.

In the event of full privatization of the GSEs, private loans will have significantly higher cost for consumers and offer equally more attractive returns for financial institutions and end investors, a result that would generate enormous political opposition among the numerous constituencies in the housing market. Needless to say, getting such a proposal through Congress should prove to be quite an achievement indeed.

[3] Sinnock, Bonnie, **"Did Warehouse Lenders Just Get a Big Break from Ginnie?,"** *American Banker*, December 21, 2016

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