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Treasury Plan Keeps GSE Status Quo—For Now

The Trump administration's recently announced plan to reform government-sponsored enterprises Fannie Mae and Freddie Mac allows the agencies leeway to continue multifamily lending at recent record levels—at least until the end of 2020.

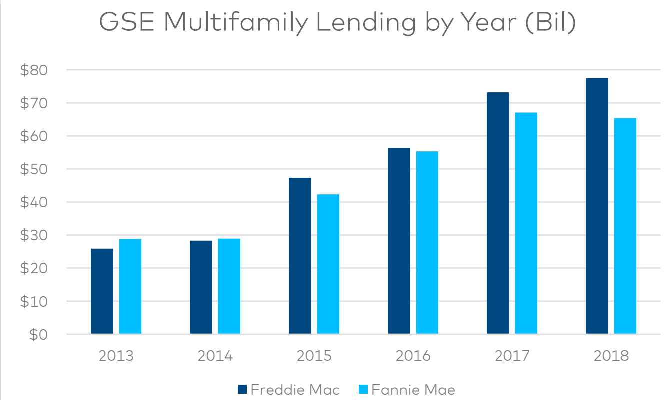
The plan comes as somewhat of a surprise since members of the administration—particularly Federal Housing Finance Administration director Mark Calabria—talked during the runup to the announcement about reigning in the GSEs' market share.

Fannie and Freddie generated nearly half of multifamily mortgage volume in 2017 and 2018, up from 28 percent as recently as 2014, according to the FHFA. Meanwhile, the FHFA said the agencies' share of the total outstanding multifamily debt has increased to 40 percent at year-end 2018, up from 25 percent in 2007.

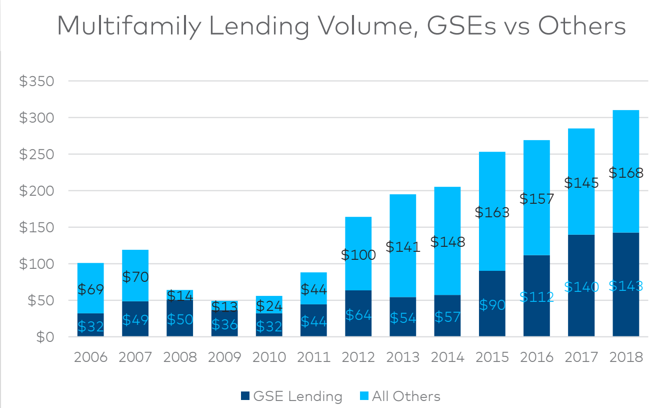
Yet the FHFA set caps for the next five quarters that will allow Fannie and Freddie to cumulatively grow. The two agencies can produce $100 billion of loans apiece between the fourth quarter of 2019 and the end of 2020, or $20 billion per quarter. The GSEs generated roughly $145 billion of loans through its correspondent programs in 2018, while the cap essentially sets volume at $160 billion combined for 2020. Freddie funded $77.5 billion of loans in 2018, up from $25.9 billion in 2013. Fannie funded $65.4 billion in 2018, up from $28.8 billion in 2013.

Draft proposals circulating before the Treasury announcement encompassed sharp reductions in the agencies loan caps. "But the way it came out allowed us to maintain our footprint," said one pleasantly surprised GSE executive.

While the administration's decision to retain current loan levels may have caught some off guard, it reflects the political reality of the moment. Unlike a decade ago, the mortgage system is not currently broken and there is little public pressure for action. And any major changes to the GSEs charters that are subject to legislative action are not likely to get done until after a new president and Congress are seated in 2020.



Source: FHFA, Mortgage Bankers Association & CREFC



Source: American Council of Life Insurers (ACLI), FDIC, Trepp, Mortgage Bankers Association & Fannie Mae Multifamily Economic Research

Administrative Changes Imposed

That's not to say there are no immediate changes or that fundamental changes won't be forthcoming. The Treasury Department's housing reform plan contains changes for the multifamily market in the short term and contemplates larger changes in the not-too-distant future.

The most immediate impact involves the elimination of "uncapped" lending. Fannie and Freddie have been operating with $35 billion annual limits ("caps") but an unlimited ability to finance loans that have green or affordable components. The FHFA has eliminated the exemption for the green loans, which involved lending on properties that improve energy efficiency, and will require going forward that agencies use at least 37.5 percent of capacity for properties with an affordable component.

That's just the start of the possible administrative actions that Treasury and FHFA can take. The plan aims to transition the GSEs from conservatorship and level the marketplace to allow private lenders to compete and increase market share. The plan contemplates recapitalizing the GSEs and making them adhere more closely to their core missions of providing support for affordable housing and liquidity in the housing market during downturns.

The GSEs were placed into conservatorship in 2008 in the wake of the financial crisis and the Obama administration later implemented a cash sweep that deposited their profits into the federal treasury. The Treasury plan envisions releasing the agencies from conservatorship and recapitalizing them so they can stand on their own. That involves allowing them to keep profits and building up a capital base on par with private lenders.

A study by former FHFA chair Mel Watt in 2018 said that Fannie and Freddie would need $180 billion of capital reserves to stand on their own (combined for multifamily and single-family mortgages, which are a much larger share of their assets). The biggest questions for recapitalization include how to raise the necessary capital and how that would impact the GSEs current investors.

The transition would also involve developing regulatory rules and capital requirements that are based on loan metrics such as loan-to-value ratios. Forcing Fannie and Freddie to set aside capital for losses like other lenders would reduce their pricing advantage and make private lenders more competitive. However, the developing and passing rules will require a huge amount of negotiation and take time to navigate.

Federal Backing at Issue

Yet another matter involves the GSEs relationship with the federal government. Fannie and Freddie buy multifamily loans from correspondent lenders and issue securities backed by the loans that are sold to investors. They charge a fee to guarantee the senior bonds. Freddie sells the first-loss class (known as a B-piece) to investors. Fannie sells most of the junior securities but keeps some of the risk in a loss-sharing arrangement. Both have operated with the implicit guarantee of the federal government—investors assume the Treasury will pay for losses incurred by senior bondholders. That allows them to price bonds higher and gives them a cost of capital competitors can't match.

The Treasury plan contemplates making the guarantee explicit and requiring the GSEs to pay the government for it. That would require legislative action—a slim chance in today's political environment—and negotiation on how much to charge for the guarantee.

The Treasury plan also considers creating additional agencies to compete with Fannie and Freddie. In theory, competition would create a marketplace that is more robust and less vulnerable to a failure of one of the agencies. However, creating from scratch a mortgage operation with equal capabilities would take time and a huge pool of capital, so it's not likely in the near term. Creating new agency charters is another area that would require Congressional action that is not likely in the near term.

Step in the Right Direction

Reforming the GSEs is a long-overdue step. They have been operating under temporary rules in a market that performs better when there is certainty. The Treasury plan moves in the right direction of clarifying the agencies' missions and enabling private lenders to increase market share, while trying to develop fair regulatory rules and ensuring that housing mortgage markets are not disrupted during economic downturns.

But while the general direction has been set, and some of the administrative decisions have started the agencies on the path of reform, much of the hard work and details won't be hammered out for months or even years. In the meantime, at least until the end of next year, the agencies will be able to finance multifamily properties at the same level they are doing now, which is good news for them (and property owners) but possibly frustrating to lenders that were hoping to expand market share.

—Paul Fiorilla, Director of Research

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