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What did the recent agreement with Treasury really accomplish?

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The Federal Housing Finance Agency and the U.S. Department of the Treasury announced an agreement Thursday that would allow Fannie Mae and Freddie Mac to retain more of their earnings, but now the FHFA is saying this money alone will not be enough to remove the mortgage giants from conservatorship.

“Today’s agreement that allows Fannie Mae and Freddie Mac to continue retaining earnings is a step in the right direction, but more hard work remains,” FHFA Director Mark Calabria told HousingWire. “Capital at Fannie Mae and Freddie Mac protects the housing finance system and taxpayers.

“Retained earnings alone are insufficient to adequately capitalize the enterprises. Until the enterprises can raise private capital, they are at risk of failing in the next housing crisis,” Calabria said.

In 2019, the Treasury began allowing the government-sponsored enterprises to retain a combined $45 billion in capital, $25 billion for Fannie Mae and $20 billion for Freddie Mac. As of the third quarter of 2020, Fannie Mae had retained $20.7 billion while Freddie Mac held on to $13.9 billion. Without an increase to the capital the GSEs are able to retain, they would both soon be sweeping all profits back to the Treasury.

The new agreement allows for an aggregate of about $283 billion in GSE capital retention, a move the GSEs applauded.
“This is a significant milestone and creates a path to end the conservatorship,” Fannie Mae CEO Hugh Frater said. “Continuing to rebuild our capital base will make us a fundamentally safer financial institution for the long term. I thank Secretary Mnuchin and Director Calabria for taking this important step forward. While increasing our capital base is essential, more work lies ahead to create a durable housing finance system to serve future generations of homeowners and renters of all income levels, through good times and bad. We look forward to working with Treasury, FHFA and other policymakers to advance that goal.”

Freddie Mac’s response was similar:

“In 2019, Freddie Mac began building capital to prepare the company for its exit from conservatorship,” Freddie Mac President Mike Hutchins said. “Since then, we’ve made good progress, going from approximately $3 billion in capital to $13.9 billion at the end of third quarter 2020. Today’s announcement will allow us to continue down the road to our next chapter, ensuring we can continue carrying out our mission in a safe and sound manner.”

Others, however, worried that this increase could encourage the GSEs to focus more on their profit margins than on serving the underserved parts of the market.

“NAR appreciates administration efforts to ensure market stability and liquidity during the ongoing pandemic,” the National Association of Realtors said in a statement. “The nation’s largest trade association is concerned, however, that these changes may limit the enterprises’ ability to appropriately serve the overall U.S. housing market as intended, most notably as it relates to first-time buyers, those in underserved communities, investor properties and second home purchases.”

And Democrats are furious about the move.
After the agreement was announced, Rep. Maxine Waters, D-Calif. and chairwoman of the House Committee on Financial Services, released a fiery statement.

“It is simply unacceptable that Treasury Secretary Steven Mnuchin and Federal Housing Finance Agency Director Mark Calabria are moving in the last days before President-Elect Biden takes the oath of office to make major changes to the housing finance system which will have repercussions across the country, and could lock families out of homeownership,” Waters said. “I have warned both Secretary Mnuchin and Director Calabria in recent letters that they must halt any significant changes to the housing finance system that could cause a shock to the housing market – a warning which they have clearly ignored.”

In fact, she even reached out to the incoming administration, urging President-elect Joe Biden to issue a presidential memorandum on inauguration day to temporarily suspend any “midnight regulations” made by the Trump administration. She argued the suspension would give the Biden administration time to review any last minute regulations made.

Suspensions such as these are not uncommon for incoming administrations. Four years ago, just one hour after President Donald Trump was inaugurated, the U.S. Department of Housing and Urban Development suspended a last-minute reduction of mortgage insurance premiums made by the outgoing Obama administration, saying it needed time to review the cut.

However, the increase in capital retention capabilities came at a cost. The cost is a dollar-for-dollar increase in the liquidation preference of the UST’s senior preferred position, which makes raising outside capital incredibly difficult if not impossible.
A report from Compass Point Research & Trading breaks it down a little more.

“If we assume the cash on the GSE balance sheets currently counts toward the capital goal, and that the GSEs earn the $21.4B in net income on a go-forward basis, it would take over 11 years to hit the capital target through retained earnings alone,” the report states. “That, of course, does not reflect natural book growth or any other factors.”

The agreement also states that “there will be no exit until all material litigation relating to the conservatorship is resolved or settled, and the GSE has common equity tier 1 capital of at least 3% of its assets.”

Using today’s numbers as estimates, that means Fannie Mae would need $116.5 billion and Freddie Mac would need $82.6 billion, before an exit to conservatorship could be considered.

The FHFA states that, “Retained earnings alone are insufficient to adequately capitalize the enterprises,” yet building outside capital could prove difficult.

“With the UST’s senior preferred sitting atop the capital stack — and set to grow by tens of billions of dollars in the years ahead — enticing new investors could be an uphill climb,” Compass Point’s report states. “Once each GSE retains sufficient capital to meet the requirement prescribed under the rule, which is referred to as the capital reserve end date, the GSEs would begin paying a quarterly dividend that ‘will be equal to the lesser of 10% of the liquidation preference of Treasury’s senior preferred stock, or the incremental increase in the GSE’s net worth in the prior quarter.’

“Notably, however, the press release states: ‘Before the capital reserve end date, Treasury and the GSEs will determine a periodic commitment fee for Treasury’s remaining
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“Given that the 10% dividend would be on the senior preferred liquidation preference, which would have increased by tens of billion dollars at that point, the net worth sweep effectively returns unless the parties can actually agree on a periodic commitment fee construct.”

It is also worth noting that the agreement says there will be no exit until all material litigation relating to the conservatorship is resolved or settled, meaning there could be an increase in litigation settlement. This could also take up time and capital.

Other members of the housing industry chimed in, and many, such as the Mortgage Bankers Association, were thankful there would not be a rushed push for the GSEs to exit conservatorship before the Biden administration took over.

Removing the GSEs from conservatorship will now fall to Biden and his administration, where many think it may be dead on arrival.

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