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Washington Policy Flash Note

First Thoughts On GSE PSPA Agreement Changes

On January 14 the Treasury Department (UST) and Federal Housing Finance Agency (FHFA) announced an amendment to the Preferred Stock Purchase Agreements (PSPA) that govern the relationship between the UST and the GSEs. The agreement allows an aggregate of ~$283B in GSE capital retention, which positive for market stability and the longer-term effort to capitalize the GSEs. The cost of that capital retention, however, 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. The agreement also includes a provision prohibiting the GSEs from exiting conservatorship until all major litigation is resolved and the GSEs hit a capital ratio of at least 3%, the former of which could lead to a renewed interest in settlement talks among plaintiffs. Finally, the UST will produce a report on how "to restructure Treasury's investments in the GSEs" to Congress by the end of September, which is little more than Secretary Mnuchin leaving a complicated and contentious issue for his successor to address. **Consistent with the overarching mortgage policy discussion of the past decade, this agreement avoids tough decisions, punts policy questions to the next administration, and effectively leaves all stakeholders frustrated**.

We include in this update 4 sections: (1) an overview of the structural changes relating to capital retention, the senior preferred, and corresponding conservatorship commentary; (2) a detailed section on the GSE footprint requirements in the document; (3) a section with links to the pertinent documents; and (4) an annotated copy of the UST's GSE reform "Blue Print" that can be accessed via the PDF version of this document.

Overview of Capital, Senior Pref, and Conservatorship Changes

At the highest level, the agreement allows GSE capital retention up to the regulatory minimum capital, including buffers, outlined in the recently released GSE capital rule. Under that rule, as of 2Q20 the GSEs in aggregate would have been required to hold $283B in adjusted total capital. In return for allowing GSE capital retention, the liquidation preference of the Treasury Department's senior preferred will increase on a dollar-for-dollar basis until the minimum capital requirements are met. As a matter of context, the liquidation preference of the UST's aggregate senior preferred position already stands at $228.7B.

Timeline With Only Retained Earnings. 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. That, of course, does not reflect natural book growth or any other factors.

What Happens After They Hit the New Capital Retention Threshold? 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 funding commitment, to compensate taxpayers for their risk in supporting the GSEs." 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.

Conditions for Leaving Conservatorship. The UST press release states that "there will be no exit [from conservatorship] 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." Putting the litigation to the side for a moment, as of 2Q20 3% of Fannie Mae and Freddie Mac's total adjusted assets was $116.5B and 82.6B, respectively. Under this construct, we could see the GSEs exit conservatorship and operate under consent decrees, but first they would need ~$200B in capital and a clean litigation slate.

Stock Issuance. The new agreement allows up to $70B in new stock issuance for each GSE "to be used to build capital." This latitude is noteworthy, and it could prove significant at some point in the future, but 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. Furthermore, it is wholly unclear why Fannie Mae and Freddie Mac are each allowed to raise up to $70B given that Fannie Mae's book is bigger, but that is just one of many questions this document left us with.

Could This Catalyze a Shareholder Settlement? A number of clients suggested that this agreement could catalyze consideration of a litigation settlement. Specifically, the new agreement prohibits an end to conservatorship while "all material litigation relating to the conservatorship" is still outstanding. Furthermore, increasing the UST's senior preferred on a dollar-for-dollar basis fosters a sense of urgency for junior preferred and common shareholders given their placement in the GSE capital stacks. We fully agree that this letter agreement could foster shareholder settlement consideration, but the focus on that front remains the Supreme Court's Collins decision, which is expected no later than July.

Product Limitations Appear Manageable, But Limit Growth + Make Future Changes More Difficult

At first blush, the product and operational limitations in the PSPA amendment appear to be set in order to restrict future growth in the covered segments rather than reduce current activity. It was clear that Director Calabria would pursue a number of GSE footprint reduction policies and the letter agreements were consistent on that end given the further reduction in the retained portfolios, the pricing parity provision, and the new caps on both risk-layered loans and second home/investment property loans. We were somewhat surprised, however, about the hardwiring of both the recent GSE capital rule the GSE multifamily cap in the PSPA. While the multifamily cap is not a near-term concern given that it is higher than the existing 2021 cap, hardwiring the recent GSE capital rule into the document slightly complicates the process for softening the rule if a Democratic FHFA Director takes the reins later this year as expected. All of these provisions can be changes once Democrats control both the UST and FHFA, but they will be effective in the interim and carry varying degrees of political baggage. We offer our thoughts on each of these provisions below.

Letter Agreement Hardwires FHFA's GSE Capital Rule, and Modestly Increases Difficulty In Altering the Rule

The letter agreement requires the GSEs to "comply with the Enterprise Regulatory Capital Framework disregarding any subsequent amendment or other modification to the rule." The inclusion of this provision is noteworthy in two respects. First, the FHFA's GSE capital rule will almost certainly be softened by the next FHFA Director, but requiring compliance in the interim will impact GSE business decisions, especially relating to CRT given the onerous treatment of that product line. Second, and perhaps more importantly, the letter agreement requires compliance with Director Calabria's final capital rule by direct reference, which increases the difficulty associated with softening the capital rule in the future. In order to secure expected changes to the GSE capital rule, the next FHFA Director will have to alter the GSE capital framework and secure another PSPA change releasing the GSEs from compliance with Director Calabria's rule. Both of these hurdles can be cleared by the next Director, but the latter hurdle was not present one day ago. Please see HERE for our note on the FHFA's final GSE capital rule.

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Limits the Acquisition of Loans With Multiple Higher-Risk Characteristics

Specifically, the letter agreements include the following product limitation: "A maximum of 6% of purchase money mortgages and maximum of 3% of refinancing mortgages over the trailing 52-week period can have two or more higher risk characteristics at origination: combined loan-to-value (LTV) greater than 90%; debt-to-income ratio greater than 45%; and FICO (or equivalent credit score) less than 680."

Our sense is that this requirement is manageable given the current book of business at the GSEs. For example, Fannie Mae revised DU's risk assessment framework to limit risk layering in 2018. To that end, Fannie Mae's 3Q20 update provides sizing for each of the segments in focus as a percentage of total YTD single-family acquisitions: DTI >45% = 13%, LTV >90% =13%, FICO <680 = 4%. While the immediate impact is likely muted, there are viable questions regarding whether these limitations could ultimately impact either the affordable housing mission or the countercyclical role of the GSEs.

Second Home/Investment Property Capped at 7%

The letter agreement states, "The GSEs will limit the acquisition of single-family mortgage loans secured by second homes and investment properties to 7% of single-family acquisitions — aligned with their current levels — over the preceding 52-week period."

As of 3Q20, second homes and investment properties represented a combined 8% of Fannie Mae 's book and 6% of Freddie Mac 's book. The second home/investment cap is clearly manageable at 7%, but with the GSE hovering on each side of the new threshold there will not be meaningful growth in these segments.

Multifamily Cap Hardwired, but It Doesn't Appear Terrible At First Blush

The GSE multifamily cap construct is now hardwired in the PSPAs with some important tweaks. The letter agreement states, "Each GSE will cap multifamily acquisitions at $80 billion over the trailing 52-week period and will require that 50% of these acquisitions are mission driven, as defined by FHFA." Also, the headline cap figure will move annually with CPI. This compares to the FHFA's most recent multifamily cap, which set a $70B cap for 2021, increased the mission-driven threshold from 37.5% to 50% YoY, and introduced a new 20% threshold sub-mandate for units at or below 60% AMI. The PSPA's changes appear manageable as the $80B figure is above the existing $70B cap for 2021 and the primary mission-driven requirement is the same, but there are important questions that need to be answered:

- How will switching from an annual cap to a 52-week trailing cap impact GSE pipeline management?
- Is linking the cap to CPI sufficient to provide support to the market over the long-term and in times of acute stress?
- Is the new 20% threshold sub-mandate for units at or below 60% AMI still in place for 2021?
- How should we think about the interplay with the GSE capital rule given that both are now hardwired into the PSPA?
- The FHFA just increased the mission-driven threshold to 50% and the new standard is therefore untested in the marketplace. Since this section is dedicated to questions, we will ask: Is it wise to hardwire an untested mission-driven requirement for GSE multifamily lending into the PSPAs?

Hardwiring the multifamily cap should have no near-term market impact given that the new threshold is above the preexisting caps for 2021, and we should welcome some structural stability in the construct, but there are viable questions over the medium- to longer-term. Please see HERE for our note on the most recent GSE multifamily decision.

Pricing Parity Provision As Expected, but Volume Cap A New Twist

The agreements "codify FHFA conservatorship directives that require the GSEs to purchase loans for cash consideration, and to operate this cash window with non-discriminatory pricing." This pricing parity provision was expected. The unexpected twist in this section is a new mandate that "each GSE will limit volume purchased through the cash window to $1.5 billion per lender during any period comprising four calendar quarters." We will provide more data on this provision in a later note.

Additional Product Limitations Manageable

By July 1, 2021, the GSEs must implement a program that "will limit the acquisition of single-family mortgage loans to (i) qualified mortgages, (ii) loans exempt from the CFPB's ability-to-repay requirement, (iii) loans for investment property subject to the restrictions above, (iv) refinancing loans with streamlined underwriting for high loan-to-value ratios, (v) loans originated with temporary underwriting flexibilities due to exigent circumstances, and (vi) loans secured by manufactured housing." At first blush, this does not appear to have a meaningful impact on credit availability given the reference to the recently revised Qualified Mortgage rule and other existing offerings.

Further Reduction in Retained Portfolios Least Surprising Element of Amendment

The letter agreement states, "The PSPA cap on the GSEs' retained mortgage portfolios will be lowered from the current cap of $250 billion to $225 billion by the end of 2022." The retained portfolios at Fannie Mae and Freddie Mac stood at $163B and $193B, respectively, as of November 2020.

Notes On Treasury's GSE Reform Blueprint

In the PDF version of this document we include a copy of the, " Treasury Department Blueprint on Next Steps for GSE Reform ." Rather than summarize the document, we highlighted the release and put a handful of notes in the margins.

Additional Resources

- UST press release can be accessed HERE
- FHFA press release can be accessed HERE
- Executed Letter Agreement for Fannie Mae can be accessed HERE
- Executed Letter Agreement for Freddie Mac can be accessed HERE
- Treasury Department Blueprint on Next Steps for GSE Reform can be accessed HERE

U.S. Department of the Treasury
Office of Public Affairs

IB: Rather than summarize this document, we provide below a highlighted version with our notes in the margin.

Press Release: January 14, 2021
Contact: Treasury Public Affairs, (202) 622-2960

Treasury Department Blueprint on Next Steps for GSE Reform

On January 14, 2021, Treasury and the Federal Housing Finance Agency (FHFA) agreed to amend the Preferred Stock Purchase Agreements (PSPAs) to move Fannie Mae and Freddie Mac (the GSEs) toward capitalization levels that are consistent with their size, risk, and importance to the U.S. economy. These amendments to the PSPAs are consistent with objectives set forth in Treasury's September 2019 Housing Reform Plan.

The conservatorships of the GSEs were not meant to be indefinite. Before the GSEs can operate outside of conservatorship, however, significant issues remain to be addressed. Additional reforms will be necessary to implement a shareholder-owned governance structure that attracts private capital and promotes market discipline while fulfilling their charter mandates, including to promote access to mortgage credit throughout the nation.

Treasury and FHFA have been working to identify and assess strategic options to terminate the conservatorships and raise capital, including identifying any necessary legislation for reform of the GSEs. The PSPA changes today provide a roadmap for Treasury, in consultation with FHFA, to work to restructure Treasury's investments in the GSEs and to deliver a proposal describing this work to Congress by September 30, 2021. While Treasury will continue to evaluate potential administrative actions to end the conservatorships, Treasury maintains that Congress is best positioned to adopt comprehensive housing finance reform.

IB: There will be a plan addressing how to "restructure Treasury's investments in the GSEs" by the end of September... a plan that will be written by a new Treasury Secretary in consultation, potentially, with a new FHFA Director

The work of Treasury and FHFA should seek to facilitate the GSEs' orderly exit from conservatorship, ensure Treasury is appropriately compensated, and permit the GSEs to raise third-party capital and make distributions as appropriate. Five key considerations should inform Treasury's continued work with FHFA. Addressing these issues will bolster reform, whether administrative or legislative, and should help achieve the bipartisan support necessary to make reform successful and durable.

- **Build GSE Equity Capital**: The GSEs should continue to build – or, when appropriate, raise – sufficient equity capital to facilitate their ability to operate through a severe downturn.

Consistent with the findings of the Financial Stability Oversight Council in September 2020, FHFA's recently finalized capital framework promotes taxpayer protection and the GSEs' ability to continue to meet their missions. The PSPA changes announced today will promote the GSEs' recapitalization by ending the net worth sweep and permitting the GSEs to retain capital up to their regulatory capital requirements under FHFA's new framework.

IB: It remains unclear what the definition of "appropriately compensated" is in this context, which is a key question

- **Determine GSE Capital Structure**: Third-party capital, raised in the equity markets, would expedite the GSEs' ability to meet their regulatory capital requirements. However, the current capital structures of the GSEs, and pending litigation related to the conservatorships and previous amendments to the PSPAs, complicate the GSEs' valuations and capital-raising processes. These issues must be addressed to facilitate the GSEs' capital restructuring and eventual exit from conservatorship. The changes announced today include a commitment for Treasury to work to address its interests in the GSEs in a way that facilitates the GSEs' orderly exit from conservatorship, ensures that Treasury is appropriately compensated, and permits the GSEs to raise third-party capital and make distributions as appropriate.

IB: Congress has shown only a fleeting interest in mortgage finance reform. Perhaps this time is different, but we expect other items will take priority and the same headwinds that have hampered progress in the past remain.

- **Set Commitment Fee for Ongoing Government Support**: Treasury supports legislative reform that authorizes an explicit, full faith and credit federal guarantee for the GSEs' mortgage-backed securities. Taxpayers should be compensated for this support consistent with the pricing for guarantees of similar risk. Today, taxpayers support the GSEs through $254 billion of remaining funding commitments under the PSPAs. Under the PSPA changes announced today, to compensate taxpayers for this support, Treasury and FHFA will determine and impose a periodic commitment fee once the GSEs have retained capital up to their regulatory capital requirements under FHFA's new framework.

IB: While structuring a fee construct for a $254B backstop is far from easy, there was some thought this amendment would include a PCF

- **Establish Appropriate Pricing Oversight**: The GSEs have significant pricing power over mortgage credit in the United States, due to their size and privileged access to federal support. Post-conservatorship, FHFA should continue its conservatorship-era practice of pricing oversight. This oversight should not seek to cap the GSEs' returns in a way that sacrifices safety and soundness in order to achieve policy objectives, or that forces taxpayers to bear undue risk for their ongoing support of the GSEs. Additionally, pricing oversight should seek to prevent the benefits of federal support from being used to compensate management or shareholders rather than supporting borrowers and renters. The PSPA changes announced today codify an important conservatorship-era GSE reform by prohibiting volume-based pricing discounts for loans delivered to the GSEs through their cash windows.

- **Assess Appropriate Market Concentration**: Further study is needed to determine the optimal number of mortgage guarantors to achieve the GSEs' mission. There are currently two chartered GSEs, but legislative reform could authorize FHFA to charter additional competitor guarantors to the GSEs and direct FHFA to re-charter each GSE on the same charter available to these potential competitors. A less concentrated secondary market could foster competition and promote innovation, with respect to not only the underwriting and pricing of mortgage loans, but also the services provided to lenders. However, given high barriers to entry, even with FHFA chartering authority, additional entrants may not be forthcoming. Therefore, appropriate consideration should also be given to whether consolidation of the GSEs' operations into a single entity would more efficiently fulfill their mission and promote the interests of stakeholders, including taxpayers.

IB: On the one hand, we should think about providing FHFA chartering authority and allow for multiple guarantors. On the other hand, maybe we should just consolidate the two GSEs into one. While reading this section, we envisioned the Scarecrow from the "Wizard of Oz" pointing in opposite directions...simultaneously.

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