



Housing Finance Reform and Taxpayer Protection Act of 2014



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Mercer Management Consulting
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The heads of the Senate Banking Committee, Senators Tim Johnson (D., SD) and Mike Crapo (R., ID) have introduced a bipartisan bill, "Housing Finance Reform and Taxpayer Protection Act of 2014" (S. 1217), proposing a framework for housing finance reform. Under this bill, Fannie Mae and Freddie Mac would be eliminated and replaced by a new independent agency, the Federal Mortgage Insurance Corporation (FMIC), which would have supervision and examination powers over the loan guarantors and aggregators in the new system. The proposal would set up a securitization platform of FMIC-wrapped mortgage-backed securities (MBS) with an explicit government backstop, but would require private capital to bear a 10% first loss piece.

*In this Q&A, **Portfolio Manager Bonnie Wongtrakool** further explains the policy and market implications, as well as possible timelines should the bill actually pass both the House and Senate.*

Q: What are the main differences between the Johnson-Crapo Bill and Corker-Warner Bill ("Housing Finance Reform and Taxpayer Protection Act of 2013"), which was introduced late last year?

A: The two bills are quite similar, given that the Johnson-Crapo Bill uses the Corker-Warner Bill as a base. The main difference is that government-sponsored enterprises (GSEs) would move from conservatorship into receivership (and ultimately wind down) in the Johnson-Crapo Bill, which would result in Fannie Mae and Freddie Mac obligations carrying an explicit government guarantee.

On the single-family residential front, the Johnson-Crapo Bill would leave the current loan limits in high cost areas intact, whereas Corker-Warner would reduce those limits to 417,000 over six years. In addition, Johnson-Crapo would eliminate Fannie Mae and Freddie Mac's single-family affordable housing goals, but establish a housing fund which would be funded through an FMIC user fee of 10 basis points.

With respect to the multi-family sector, Johnson-Crapo would allow for the spin off of the multi-family programs of Fannie Mae and Freddie Mac, while Corker-Warner would fold them into the new FMIC entity. At least 60% of the rental units financed by each multi-family guarantor would be required to be affordable to low-income families (defined as families with incomes less than or equal to 80% of area median income).

From a procedural standpoint, the odds of the Johnson-Crapo Bill getting through the Senate Banking Committee are thought to be higher than those of the Corker-Warner Bill, but it is still not expected to make it through the full House and Senate.

Q: Who would be obligated to bear the first 10% loss piece?

A: The underwriter of the loans would initially bear the risk of the 10% first loss piece, but what is unspecified in the bill is how that risk could be transferred to other parties. The risk could be shared with either private mortgage insurers or investors who would hold this risk through securitization or credit-linked instruments similar to the recent GSE risk-sharing transactions. Ultimately the extent and mechanism for the transfer would be dependent on risk retention rules and ownership of the loans.

Q: What is the expected timeline and likelihood of the final bill passage and implementation? When would the GSEs stop issuing securities and when would the first FMIC security be issued?

A: The draft bill is expected to be voted on by the Senate Banking Committee (SBC) by the last week of March. After SBC approval, it would need to be considered by the House Financial Services Committee, the full Senate,

and the full House, and amended as needed. The Senate and House would then need to pass the reconciled bill and the President would need to sign it. There is no way to predict the timeline for the negotiation process, and the chances of it passing through the House are limited, but our expectation is the negotiation and voting process will take several years.

If Johnson-Crapo were to pass, the FMIC would be created six months after its enactment, and the transition to the new system would need to occur within five years, with the option for extensions if needed to prevent market disruptions and undue volatility in borrowing costs. In this chain of events, we estimate that issuance of the first security would occur three to five years from now at the earliest.

Q: What are the key obstacles for the GSE reform?

A: The main obstacle to GSE reform remains the conflict between Republican opposition to government guarantee on mortgage credit and Democratic desire to maintain housing affordability. The Republican concern is addressed by increasing the first loss piece, but this results in a higher primary rate to the consumer in contravention of the Democratic agenda.

Q: What would be the market impact to existing agency debentures and MBS before and after the reform? Would there be any spread widening or tightening?

A: Johnson-Crapo would bring Fannie Mae and Freddie Mac into receivership, which would bring agency obligations onto the Treasury balance sheet and turn the implicit guarantee into an explicit one. Furthermore, the bill would allow the FMIC to exchange existing GSE securities into new FMIC-guaranteed MBS just six months after the bill's enactment. This change from an implicit to an explicit guarantee should tighten spreads on agency debentures and MBS at the margin. Ginnie Maes would not benefit, since they are already full faith and credit. The key question is the impact on liquidity of the existing TBA market. We would expect the depth of the FMIC market to increase over time and of the existing TBA market to decrease over time.

Q: How would the reform affect the credit views of Fannie Mae, Freddie Mac, and FMIC?

A: From a credit (and rating agency) perspective, Fannie Mae, Freddie Mac and FMIC would be viewed similarly to Ginnie Mae, as a government agency.

Q: Would there be any differences in the risk characteristics for holding FMIC securities versus the existing agency MBS or debentures?

A: The credit risk of holding the guaranteed portion of FMIC-wrapped securities would be identical to holding Ginnie Mae MBS, given that both would carry an explicit government guarantee. The convexity profile would not be substantially different from agency MBS given that it would largely adhere to Qualified Mortgage (QM) standards, aside from requiring a 5% down payment with a 3.5% exception for first-time homebuyers (QM does not specify any minimum down payment).

Q: How would GSE preferred and common stockholders be affected by this proposal?

A: Freddie Mac and Fannie Mae common and preferred stock have steadily rallied over the past year on speculation that some portion of the proceeds from a liquidation of the GSEs would flow through to the equity holders after repayment of the Treasury's \$189.4 billion of senior preferred obligations. On the positive side from an equity perspective, the Johnson-Crapo Bill allows for assets and liabilities of Fannie Mae and Freddie Mac to be sold to private investors. However, in August 2012, the Treasury Senior Preferred Purchase Agreement was amended so that the government's preferred shares, which previously earned a 10% dividend, would instead capture all quarterly profits earned by the GSEs. Under this arrangement, the Johnson-Crapo Bill would have no practical effect on the fate of the equity stakeholders because of the profit sweep into the Treasury.

However, a number of shareholders have sued the Treasury to challenge the legal validity of this amendment, arguing that the changes in terms are unconstitutional takings and illegal self-dealing between the Treasury and the Federal Housing Finance Authority. Thus, the value of the preferred and common equity hinges not on the

Johnson-Crapo Bill, but on the outcome of the litigation. As Senator Crapo himself commented in a March 13 Bloomberg interview, “[Shareholders] have filed suit right now in order to challenge the way that the current conservatorship is managing the current profitability of Fannie Mae and Freddie Mac. We are not necessarily going to dictate the outcome of that. That will be a decision that’s made in the courts.”

Last month, a federal judge ruled that one shareholder group led by Perry Capital and Fairholme Capital Management must be allowed to proceed with discovery before she will consider the government’s motion to dismiss the claims. While there is no way to handicap how the litigation will unfold, we believe that Fannie Mae and Freddie Mac preferred and common equity will eventually recoup minimal value from the wind-down process.

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