Cumberland Advisors Market Commentary – Chris Whalen on GSEs

Several folks have asked us about the status of the GSEs under the Biden regime. Some may be invested in some of the troubled securities issued by GSEs. Some argue that the US Treasury Secretary can rectify the problem without the help of Congress. We do not agree. We do not expect any help for the GSEs during the next administration. We don't see why any politician would vote in favor of a GSE bailout and put her or his career at risk. No one seems ready to tackle this difficult problem. All prefer to "kick the can down the road" and leave the GSEs in status quo limbo land. There is also an economic argument in favor of the status quo. Changing it might shock the mortgage market and upset the implementing of monetary policy. (GSE debt is used by the Fed.)

Longtime friend and Whalen Global Advisors chairman Chris Whalen summarizes the situation this way:

"The prospective ejection of the GSEs, Fannie Mae and Freddie Mac, from government control seems finally to be dead for the next four years. While Federal Housing Finance Agency head Mark Calabria has made a lot of noise about ending the conservatorship of the GSEs, in fact the possibility was never real."

Today, we have a guest column on the GSEs from Chris Whalen. We concur with his views, and he has articulated them much better than we can do. Chris has lots of experience and deep expertise in the areas of banking, mortgage finance, and the fintech sector. We thank him for giving us permission to share his words and analysis. We've copied the text below.

Chris has a newsletter and a research service. The service is behind a paywall, and we suggest that serious investors consider it. Information is available here: https://www.theinstitutionalriskanalyst.com/plans-pricing. The *Institutional Risk Analyst* newsletter is currently free, and readers may want to subscribe. You can do so by submitting your email address at the website: https://www.theinstitutionalriskanalyst.com/.

Now let's get to Chris Whalen and the GSEs. (You can also view this issue of *The Institutional Risk Analyst* online, here: https://www.theinstitutionalriskanalyst.com/post/nonbank-update-pennymac-financial-services.)

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New York | In the Black Friday edition of *The Institutional Risk Analyst*, we survey the political economy in the wake of the 2020 election in the US. It seems that Americans no longer will have the convenient distraction of **President Donald Trump** upon which to blame various woes, meaning that the grim financial and economic reality facing society is now front and center. And one of our favorite examples of the growing financial malaise in America is housing finance.

The prospective ejection of the GSEs, **Fannie Mae** and **Freddie Mac**, from government control seems finally to be dead for the next four years. While **Federal Housing Finance Agency** head **Mark Calabria** has made a lot of noise about ending the conservatorship of the GSEs, in fact the possibility was never real. All that noise just provided opportunities for insider trading, Washington's favorite choice of entertainment and enrichment.

When rumors emerged a week or so ago that the Lame Duck Trump Administration might release the GSEs from conservatorship, we laughed. The actual release was never a real possibility. This nonsense talk did, however, provide a nice pop in the prices of GSE common and preferred equity. This glad fact allowed some hedge funds and MCs to take a few more dollars off the table before the coffin is sealed.

All of the announcements about the GSEs over the past four years could be generously described as securities market manipulation. Why the Securities and Exchange Commission does not investigate the correlation between these leaks regarding the supposed "release" and trading in GSE securities we'll never know.Yes, it is true that there were discussions in the Trump White House about a Lame Duck release strategy, but the career staff at the US Treasury and the Office of Management and Budget, for starts, would never allow such a crazed scheme to proceed.

As with the case of the government equity stake in **General Motors (NYSE:GM)**, the government must be repaid for its investment in Fannie Mae and Freddie Mac. And no, the sweep payments are not a repayment of the investment by US taxpayers. When the GSEs are released and the government's shares are acquired *by private investors*, then the US government will be made whole. And at the moment, we doubt that the Treasury could get anything like book value for the shares of either GSE.

In the meantime, the sweep of income to the Treasury compensates taxpayers for guaranteeing the $6 trillion in GSE debt and, significantly, to also wrap the two corporate entities in “AAA” ratings. Upon release, lest we forget, the GSEs must compensate the Treasury for continuing to wrap the existing $6 trillion in MBS in a “AAA” rating. Say renting Uncle Sam’s full faith and credit costs 15bp per year on that $6 trillion in existing debt. This is based on the work by **Wells Fargo (NYSE:WFC)** on credit risk transfer (CRT) deals over the past few years.

Of note, this credit wrapper for the MBS won’t buy the corporate entities a “AAA” rating, meaning that the GSEs would be effectively out of the guarantee business. And thanks to the chaotic and at time contradictory policies of Director Calabria at the FHFA, the GSEs will not longer be selling risk to investors. These are two little details that are never discussed in Washington, part of what is called a “competitive analysis” in the world of public issuers.

The folks at **Citigroup (NYSE:C)** last week noted that under the capital rule most recently adopted by the FHFA, the GSEs would be required to have $280 billion in capital and maintain a bank-like 4% leverage ratio. According to their analysis, the GSEs would need to increase their guarantee fees by 40bp to almost 1% in order to remain profitable. Our reaction: Really?

As we’ve noted *ad nauseum*, the GSEs are not banks and cannot support this sort of capital structure. And the GSEs certainly can’t *raise* guarantee fees and remain competitive with other private mortgage insurers and banks. But we think that Director Calabria is smart enough to know this already. It is no accident that Freddie Mac CEO **David Brickman** has announced his departure.

You see, nobody in the bond market cares about a guarantee from a “AA” or “A” Fannie Mae at 1% annually, especially if they can buy a “AAA” wrapper from the US Treasury for 15bp.

Right? You begin to see the problem? This is why "release" can never happen.Once you separate the GSEs in credit terms from the $6 trillion in "AAA" agency MBS, the GSEs become superfluous and likely insolvent.

Take another example. How about buying credit enhancement from "AA" rated **JPMorgan (NYSE:JPM)** at 30bp for private label conforming MBS? Most banks would probably look to retain duration at the present time, but suffice to say that the big banks *could* offer credit enhanced MBS that would be more than competitive with the "private" GSEs.

Once you take the insurance business away from the GSEs, neither is viable from a competitive perspective, yet nobody in Washington ever talks about this question. Therefore, ask not when the GSEs will be released from conservatorship.Ask instead why apparently intelligent people in Washington actually spend time talking about release as though it were a real possibility.

First and foremost, Director Calabria seems more interested in crippling the GSEs operationally than making a release from government control truly possible. Former Freddie Mac CEO Don Layton, writing for the **Harvard Joint Center on Housing**, notes that the capital rule for the GSEs "seems to me to reflect far too much antipathy to the GSEs and the politics of anti-GSE advocates who have long wanted to dramatically shrink (if not eliminate) the role the two companies play in mortgage markets."

He continues: "While the FHFA is, not surprisingly, claiming that the capital rule strictly reflects professional policy considerations, I believe that this is not really true and that anti-GSE ideology is too much in the driver's seat." Layton then summarizes the situation going forward under the FHFA's ill-considered capital rule for the GSEs:

"The rule will also generate immediate pressure for a major increase in guarantee fees, which are currently based on a much lower capital requirement. Such an increase, if pursued by the FHFA, would generate incredible noise and friction in the industry and in Washington – it is not obvious how that would all play out, except to increase the desire of the Biden administration to replace Director Calabria as soon as it can." Ditto, Don.

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