Agency MBS: Market Update and Outlook

FOR PROFESSIONAL INVESTORS - January 2018

Key points

- The FHFA and the U.S. Treasury announced an agreement to allow Fannie Mae (FNMA) and Freddie Mac (FHLMC) to retain a capital buffer of $3 billion each.
- Implications of the U.S. tax reform bill will likely result in fourth quarter 2017 losses for FNMA and FHLMC and a slower pace of home price appreciation in 2018.
- We see an increasing chance that the government guarantee for FNMA/FHLMC MBS becomes explicit, which could lead to additional demand.

Fannie and Freddie Allowed to Build Capital Buffer

FNMA and FHLMC Now Able to Retain $3 Billion Each

The Federal Housing and Finance Agency (FHFA), the regulator of FNMA and FHLMC, and the U.S. Treasury announced on December 21, 2017 an agreement to allow the two entities to retain a capital buffer of $3 billion each. The capital buffer was set to go to zero in 2018. The change will provide additional financial stability for FNMA and FHLMC. The capital buffer will help prevent future drawdowns on U.S. Treasury preferred capital lines due to fluctuations in generally accepted accounting principles (GAAP) accounting earnings. We do not expect this development to have an impact on the agency MBS market.

U.S. Tax Reform

May Lead to FNMA/FHLMC Capital Injection

The tax reform bill passed by the House and Senate towards the end of December 2017 also has implications for FNMA and FHLMC, notably in regards to its treatment of deferred tax assets (DTA). Both entities have large DTA on their balance sheets. The change in the corporate tax rate from 35% to 21% will reduce the value of the DTAs at FNMA and FHLMC by about $12 billion and $6 billion, respectively. The realization of the change in value in the fourth quarter of 2017 will likely result in quarterly losses for FNMA and FHLMC. Both FNMA and FHLMC would then need to draw on the Treasury borrowing line early in 2018. We estimate that the total draw would be between $5 billion and $15 billion, depending on fourth quarter earnings.

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While this is a substantial sum, the amount is well below FNMA and FHLMC's existing credit line from the U.S. Treasury. In 2008, the U.S. Treasury promised to extend $400 billion to FNMA and FHLMC. Approximately $190 billion of the $400 billion was used in 2008, leaving $210 billion for the entities to use going forward.

We expect the Congressional reaction to be muted, as this would be viewed as a one-time event triggered by tax accounting changes and not by credit performance. And with the new capital buffers, it becomes less likely that additional draws will be needed in the future. Earnings in excess of the $3 billion buffer will still be swept to the U.S. Treasury per the terms of the 2012 preferred stock purchase agreement.

FNMA and FHLMC equity securities traded a little higher on the news. There was no reaction in valuations for FNMA and FHLMC MBS.

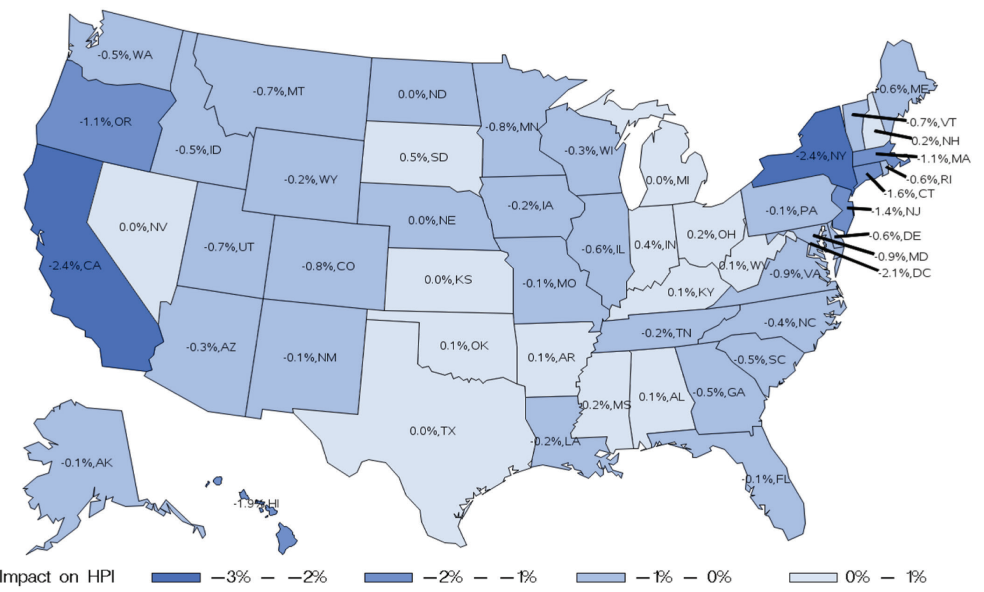
Moderate Impact on Home Price Appreciation

U.S. tax reform legislation has implications for the mortgage interest deduction, the deductibility of state and local taxes and in turn for housing markets. We see the impact of this plan as slowing down the rate of home price appreciation and in turn slowing down housing activity. This would lead to slower base levels of prepayment activity due to stronger lock in effects and less housing turnover.

The plan doubles the standard household deduction. There is a group of tax payers who, going forward, will now use the standard deduction instead of itemizing deductions for mortgage interest or for state and local taxes. For this group of tax payers, the tax advantage of owning a home versus renting will go away. There are many reasons for owning a home aside from the tax advantage. We think that at the margin under this tax there will be a decline in demand for home ownership. In turn the rate of home price appreciation will slow. This would also lead to lower levels of prepayments due to housing turnover.

Before the tax reform, we expected home prices to appreciate by 5-6% in 2017 and 2018. With the tax reform, we expect home prices to appreciate slightly slower by approximately 4-5%, with the impact varying across states.

Impact of tax reform on home prices varies across states
Overall impact of tax reform on HPI (%)



Note: Estimation is based on proposals being discussed in Congress. Specifically, we analyze the impact of changes to the tax bracket, an increase in the standard deduction, a decrease in the mortgage interest deduction limit, eliminating the deductibility of state and local income taxes and allowing the deductibility of state and local property taxes up to $10,000.
We assume that all of these proposals are part of the final bill.

Source: J.P. Morgan, Press Reports

Government-Sponsored Entity (GSE) Reform

2018 is likely to finally see GSE reform. The most likely outcome is a strengthening of the government guarantee for mortgages issued by FNMA and FHLMC.

Two key players in the debate, Senator Bob Corker and House Financial Services Committee Chairman Jeb Hensarling, have announced they will not seek re-election in 2018. We think both will be strongly motivated to pass GSE reform before their terms end in late 2018. We also think Treasury Secretary Mnuchin is on board with advancing GSE reform in 2018.

Historically Congressman Hensarling has advocated for removing the implicit government guarantee for FNMA and FHLMC agency MBS. Recently he appears to have softened his position on the backstop and government guarantee. Our view is that in order to get a GSE reform bill to move forward he will need to compromise. That means agreeing to an explicit government guarantee provided private capital is on the hook for losses as well.

Senators Bob Corker (Republican) and Mark Warner (Democrat) are planning to introduce a plan early in 2018 that would restructure FNMA and FHLMC, but retain the GSEs ability to issue government-guaranteed mortgage securities.

While it is still very early stages, we want to highlight this development as we see an increasing chance that the government guarantee for FNMA and FHLMC MBS becomes explicit. This would improve the risk weighting of FNMA and FHLMC securities, and could lead to additional demand for MBS and to further convergence of spreads between Ginnie Mae (GNMA) and conventional MBS.