GSE Activity Report

Monday, December 9, 2019

The Systemic Scarlet Letter

Summary

As previously noted, FSOC's 2019 annual report for the first time paints nonbank mortgage origination and servicing with the systemic label from which numerous outcomes – all costly – may come. Judging by the subsequent Calabria statement, next up is FSOC consideration of activity-and-practice designation, a move that could quickly lead to bank regulatory actions that redefine the nonbank business model unless or until Treasury and the banking agencies are satisfied with state, Ginnie, and FHFA constraints.

Impact

To start with, a short systemic backgrounder. The Dodd-Frank Act created the process for designating nonbanks predominately engaged in finance that are designated as systemically-important financial institutions (SIFIs) by the Financial Stability Oversight Council. The Obama Administration did so for GE, AIG, MetLife, and Prudential, but court challenge undermined Treasury's process. No additional designations ensued and, when the Trump Administration arrived, designations were reversed. There are now no designated nonbank SIFIs, although there are eight designated financial market utilities (FMUs) in the payment, settlement, and clearing arena.

At the same FSOC meeting at which the annual report was released, the Council also finalized standards shifting U.S. systemic policy from designation to the activity-and-practice designations also authorized in the Dodd-Frank Act. Little changed from FSOC's proposal, the new policy favors activity-and-practice designations that, once made by the Council, may or may not be implemented as proposed by the primary federal regulator. That regulators have the authority to do or not to do what FSOC demands was clear in the Obama Administration, when the SEC implemented only reluctantly and then very differently FSOC standards governing money-market funds.

Now what?

FSOC can designate nonbank risk exposures as systemic activities or practices, designate one or more nonbanks, or revisit the question instead of also designating Fannie and Freddie as Senate Banking recently pondered. As the new guidance stipulates and Calabria reiterated, specific designations are a last resort, most likely only for a large company seen to be on the brink of failure in order – or so it will be hoped – for regulators to get in ahead of time to figure out resolution under the Dodd-Frank orderly-liquidation authority.

FHFA could well support this for Fannie and Freddie *in extremis* to give it resolution options better designed for a crisis than those in the pre-crisis framework included in HERA, but this Administration

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is otherwise unlikely to turn the GSEs into SIFIs. None of the nonbank mortgage companies fits well into the new SIFI-designation framework, but designation for biggest is also possible under severe stress to prevent chaotic insolvency.

Outlook

This brings us back to activity-and-practice designation and what it entails. As noted, FSOC is enigmatic about its nonbank worry list, but what is says reiterates all of the servicing risks we detailed in our most recent survey of nonbank policy concerns. These lay out a framework in broad terms first for activity-and-practice designations under Dodd-Frank's statutory criteria: i.e., risk to the national economy due to sudden mortgage-market illiquidity, contagion risk to systemic financial institutions via illiquidity and insolvency risk, and risk to LMI households due to acute origination-and-servicing disruptions.

As noted, FSOC cannot order primary regulators to do anything once a systemic risk is spotted, but we think the federal banking agencies, FHFA, and HUD will hop to. The most immediate steps will likely be rapid imposition of liquidity constraints on all bank backstops through steps such as constraints on short-term funding, increased nonbank collateralization, and an array of additional solvency buffers. We also expect FSOC to press the GSEs and Ginnie to reduce servicing concentration perhaps by mandating rapid servicing transfer to regulated companies. As we have noted, MSA and other barriers to servicing at even very large regional banks are now significantly reduced. Much else is not just possible, but also probable, with timing on all of this in the ASAP box from all we hear.

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