Housing Finance Reform and Agency Supply Shortage
How These Developments May Impact Cash Portfolios

Abstract

The Johnson-Crapo bill represents another concrete step towards the resolution of the future of Fannie Mae and Freddie Mac and one that will further reduce the supply of government agency debt. This presents a serious challenge to the management of cash portfolios due to the core holdings status of agency debt. Money market fund reform may force more prime fund shareholders into the government space. Investors should prepare for the challenge by considering credit investments and longer maturities, and by locking in yield differentials today. Separately managed accounts may help cash professionals to explore options that are not available from money market funds or banks deposits.

Introduction

Within the world of financial regulatory initiatives, housing finance reform has been a key area of interest for fixed income investors. For decades, short-term cash investors have relied heavily on an ample supply of highly liquid discount notes and coupon bonds from the housing government sponsored enterprises (GSEs). However, the introduction of the Johnson-Crapo Senate bill in March 2014 may bring GSE reform one step closer to its final outcome and it may further curtail debt issuance from two of the GSEs, namely Fannie Mae (FNMA) and Freddie Mac (FHLMC). Although the process of winding down Fannie and Freddie may take years to complete, the shrinking of supply of GSE issuance in the short-term funding market may be the first major development to impact investors.

The Johnson-Crapo Legislation

On March 16, 2014, Senate Banking Committee Chairman Tim Johnson (D-South Dakota) and Ranking Member Mike Crapo (R-Idaho) unveiled a bill to reform housing finance after a broad agreement was reached amongst Committee members. The Johnson-Crapo bill, fashioned after the Corker-Warner bill in 2013, is another concrete step towards resolving the long-term future of Fannie and Freddie which currently remain under the government's conservatorship.

The bill, as proposed, will eliminate the two housing GSEs and a new Federal Mortgage Insurance Corporation (FMIC) will replace the firms' current regulator Federal Housing Finance Agency (FHFA). The FMIC will provide reinsurance on new conforming mortgage loans and its mortgage insurance fund will provide explicit government guarantees to mortgage investors once an initial 10% loss is borne by private parties. Any shortfall in the insurance fund will be replenished by a $100 billion credit line from the U.S. Treasury, and ultimately recuperated through higher future guarantee fees. As the government winds down Fannie and Freddie over a five-year period, their outstanding GSE debt and mortgage backed securities will become explicit obligations of the U.S. Treasury[1].

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At the moment, the bill appears to have enough support to pass the Senate and the White House has indicated that the bill also has President Barack Obama's endorsement. However, it will likely encounter some obstacles before becoming law. For one, the upcoming mid-term elections may delay a vote on the final bill until 2015. Fannie and Freddie's healthy cash flow contributions to Treasury coffers and the reduction of the federal deficit may present a strong disincentive to dissolve the "cash cows" in a speedy manner. And, assuming that the final bill eventually passes into law, the wind-down phase will likely take longer than the proposed five years.

Impact on Cash Portfolios

The Johnson-Crapo bill will likely have a profound impact on mortgage financing in general, but we would like to turn our focus to the impact on short-term cash markets. We see two major possible outcomes.

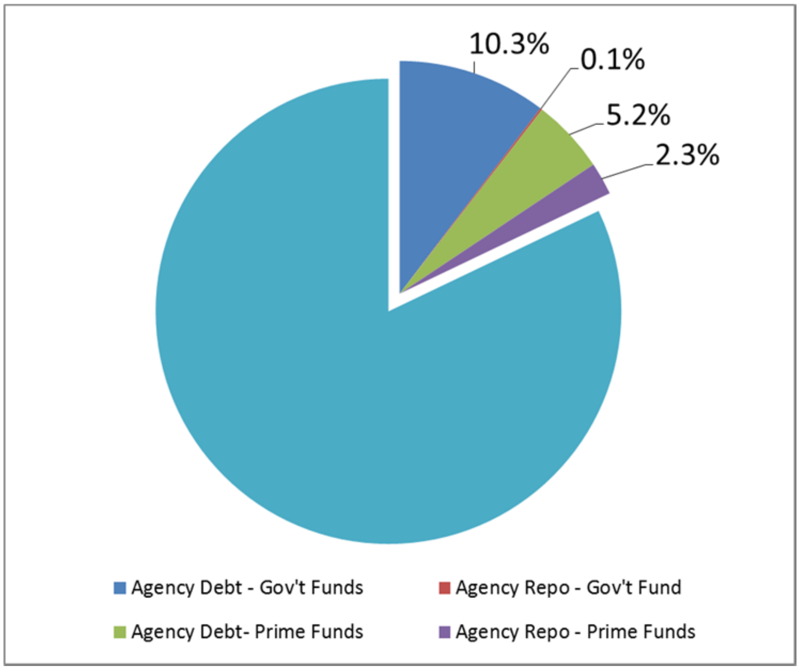
In the first, the fate of Fannie Mae and Freddie Mac finally becomes clearer. The Johnson-Crapo legislation plans to wind down the two GSEs, a path similar to two previous reform proposals. This route necessitates either a government assumption of all outstanding GSE debt or a conversion to FMIC debt carrying a federal government backing. The explicit government assumption of debt is clearly a credit positive for existing GSE debt holdings and will eliminate any spread differential to that of Treasury notes and bills.

The second outcome is a further reduction in the supply of government agency debt issuance. As the current mortgage portfolios are wound down, the reinsurance model behind the new FMIC will require little, if any, borrowing to fund future operations. The combination of a reduction in current debt and no new issuance will most certainly impact the overall supply dynamic.

GSE Debt as the Bedrock of High Quality Cash Portfolios

For decades, high quality GSE debt from Fannie and Freddie has served an important function in the cash markets and there is no ready substitute. Absent explicit restrictions, GSE debt often acts as the proxy for U.S. government securities. Fannie and Freddie also tend to be considered a "core" portfolio holding exempt from issuer concentration limits, and when a portfolio is supply constrained or when general credit market conditions worsen, GSE debt often is relied upon to keep portfolios fully invested. The prevalence of GSE debt in cash portfolios can be illustrated by recent money market fund holdings data (as reported by the Investment Company Institute).

Figure 1: Agency Debt in Money Market Mutual Funds as of March 31, 2014



Source: ICI, Statistics, Money Market Fund Assets

Government agency debt composes 29.6% of the holdings of government money market funds in the U.S. as of March 31, 2014, and another 0.4% are held in government repurchase agreements (repos)[2]. Approximately 9.4% of prime funds are invested in government agency debt and a further 4.1% in government repos. From reviewing net assets of $921 billion for government funds and $1,451 billion for prime funds, we estimate a total of $472 billion in government securities and government repos, or roughly 18% of the money market fund industry (See Figure 1). These figures include all federal agencies, although other than Federal Home Loan Bank (FHLB) debt, other agency debt holdings are largely immaterial.

Declining Debt Outstanding and Issuance Over Time

The high concentration of GSE debt in cash portfolios today is actually lower than in 2008 due to declining new issuances. The winding down of Fannie and Freddie will only add to this trend.

Figure 2a: Agency Debt Outstanding

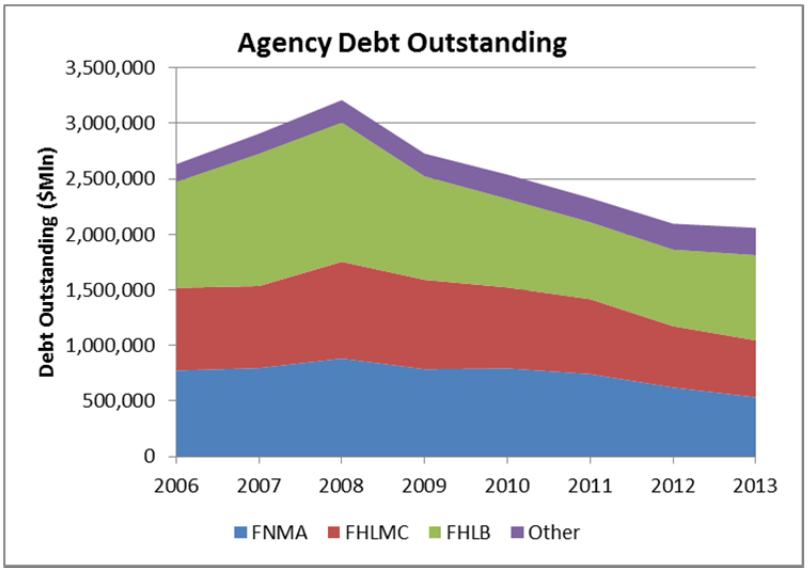
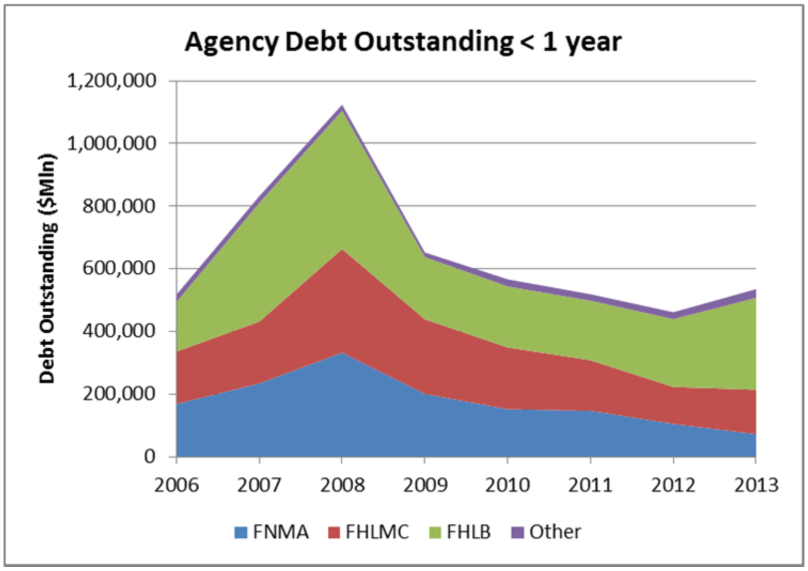


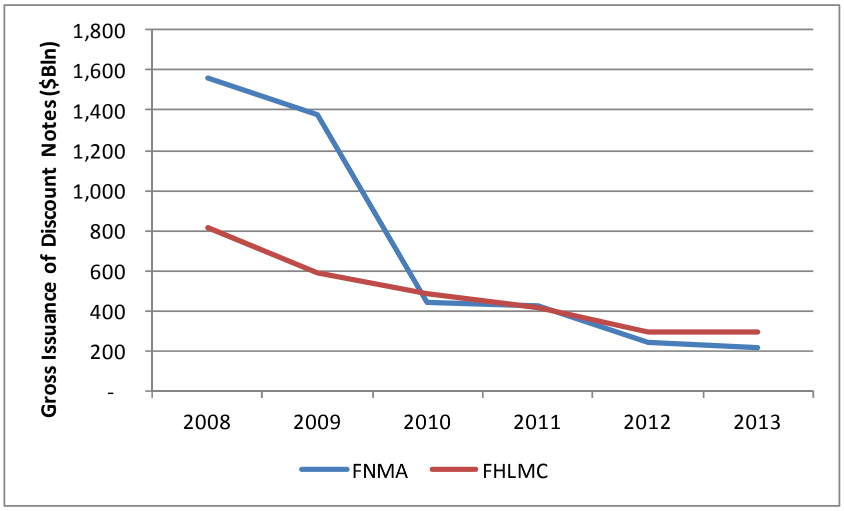
Figure 2b: Agency Debt Outstanding (< 1 year maturity)



Source: SIFMA, US Agency Debt Outstanding, updated 3/14/14

Figure 2a shows the general reduction of overall agency debt outstanding since 2008, much of which can be attributed to the reduction in Fannie and Freddie debt. Figure 2b shows a more pronounced reduction in Fannie and Freddie short-term debt, which declined by 68% from a combined $663 billion in 2008 to $214 billion in 2013. The reduction in FHLB short-term debt was 34% over the same period.

Figure 3: Gross Discount Notes Issuance (<1 year maturity)



Source: Fannie Mae and Freddie Mac

The end of the mortgage boom was a main factor behind the debt reduction. The planned winding down of existing mortgage portfolios at Fannie Mae and Freddie Mac under the conservatorship agreement directly resulted in reduced gross issuance in short-term discount notes (See Figure 3). Johnson-Crapo, if passed, may further accelerate the decline already seen in debt outstanding and new issuance.

Impact from Money Market Fund Reform

The supply shortage in short-term GSE debt may also be further compounded by pending money market mutual fund reform. The likely exemption of government funds from the floating net asset value (NAV) treatment, should the Securities and Exchange Commission adopt the alternative, may encourage substantial reallocation by institutional prime shareholders into government funds, and worsen the supply drought.

Assuming that only 30% of the $928 billion invested in institutional prime fund shares move to government funds, the market will need to absorb an additional $278 billion in demand for Treasury, agency debt and government repos. The question of how government funds will accommodate this influx of funds while remaining viable cash management tools remains to be answered.

Preparation through Diversification

A shortage of high quality investment options is not a new challenge for corporate treasury professionals. The eventual resolution of GSE reform presents a critical challenge to cash investors due to the GSEs' core holding status today. At the moment, the fate of money market fund reform and the Johnson-Crapo bill remain uncertain, but investors need to be prepared for the inevitable loss of a core asset class. It is not too early to consider other alternatives to diversify one's investment options.

Credit Investments: For accounts whose guidelines currently restrict investments to government securities or government money market funds, attention should turn to high quality credit investments such as corporate debt. For accounts that allow corporate securities, consider additional foreign non-corporate and high grade asset-backed issuers.

Longer Maturities: Much of the discussion regarding supply shortage has focused on debt maturities within one year. Considering debt with slightly longer maturities will help to alleviate the supply crunch by avoiding competition with money market funds for securities. Money market funds may only use floating rate government debt with final maturities of up to two years, so the ability to own debt longer than two years will open up more options.

Lock in High Quality: Should Johnson-Crapo clear both chambers of Congress, Fannie Mae and Freddie Mac debt will be backed by the full faith and credit of the U.S. government. Accounts with room in their portfolios may consider taking advantage of the current yield differential to Treasury debt and lock in positions for yield pickup.

Separately Managed Accounts: A separately managed short-duration portfolio seems the logical vehicle through which to implement these strategies. New credit selections, longer maturities and relative value considerations all call for a customized approach to managing liquidity portfolios. By working with internal or external managers, treasury professionals may access additional investment alternatives beyond government money funds, prime money funds and bank deposits.

[1] A summary of the Johnson-Crapo bill can be found on the Senate Banking Committee's website under "Johnson, Crapo Release Housing Finance Reform Text" dated March 16, 2014, http://www.banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord_id=f8f64d97-d732-3aa9-e966-6040d7dbf169

[2] Source: Investment Company Institute Statistics "Report: Monthly Taxable Money Market Fund Portfolio Summary, March 214 (xls)" published on April 16, 2014.