The Daily Dish

A Capital Idea About Fannie and Freddie

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Eakinomics: A Capital Idea About Fannie and Freddie

Remember Fannie Mae ("Fannie") and Freddie Mac ("Freddie"), the housing government-sponsored enterprises (GSEs)? These behemoths were constructed like the proverbial camel – one part profit-seeking private entity, one part affordable-housing mission, and one (very tiny) part capital buffer against calamity. Calamity, of course, happened in 2008; housing finance cratered, the economy followed, and the GSEs ended up being wards of the state.

In the worst quarter of the Great Recession, Q4 of 2008, gross domestic product fell 2.2 percent. Compared with the 11 percent decline expected in Q2 of 2020, this drop doesn't seem as daunting as it used to, but it is still useful to think about ways to make Fannie and Freddie more resilient, housing markets and housing finance sounder, and the economy safer. For years, comprehensive reform of the GSEs (for example, changing the GSE charters, or other reform that would require an Act of Congress) was seen as the path to those goals, but the Trump Administration has decided to pursue ending the conservatorship and allowing the GSEs to again operate as regulated private firms.

A key aspect of those regulations will be the amount of capital that Fannie and Freddie are required to hold. Wednesday the Federal Housing Finance Agency (FHFA) released its proposed rule for those capital requirements. AAF's Thomas Wade has a comprehensive review of the rule, but the short version is that the FHFA wants Fannie and Freddie to behave much more like a big bank.

Step one is to simply hold a *lot* more capital – "The 2020 proposed rule would require Fannie and Freddie to hold a combined $244 billion in capital, far higher than the combined $23.5 billion they currently hold" – and in many cases higher quality capital as well. Step two is to add on additional capital buffers – "a stress capital buffer, a stability capital buffer, and a countercyclical capital buffer." Importantly, these additional capital buffers are supplementary. Thus, the $244 billion is probably best viewed as the bare minimum of capital necessary for the FHFA to allow the GSEs to exit conservatorship.

Legislative reforms of the GSEs remain the best way to improve the safety and soundness of U.S. housing finance. But in the absence of more fundamental reform, holding a lot of private capital to absorb the consequences of negative shocks cures a lot of sins. $244 billion might seem like a lot, but let us hope that the FHFA ultimately requires a lot more than that.