The Daily Dish

Risky Business

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Eakinomics: Risky Business

No, no, no — not Tom Cruise in his tighty-whities. I want to talk about the path forward on policy for the housing government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac! Recall — as nicely detailed by AAF's Thomas Wade — that the administration has released its blueprint for housing finance reform in twin reports from the Departments of the Treasury and Housing and Urban Development (HUD). Putting aside the not-going-to-happen legislative reforms, the future of the GSEs will be dictated by the administrative decisions of the U.S. Treasury and Federal Housing Finance Agency (FHFA).

That process got kicked off yesterday with the announcement that Treasury had agreed to modified terms of the Preferred Stock Purchase Agreements for Fannie Mae and Freddie Mac. Since 2012, the price of saving the GSEs has been that the Treasury undertook a "profit sweep" and did not permit the GSEs to retain their earnings (with the exception of a very, very small amount of capital). Now Fannie will be allowed to retain $25 billion, while Freddie will be able to retain $20 billion. As FHFA Director Mark Calabria said in a statement, "The Enterprises are leveraged nearly 1,000-to-one, ensuring they would fail during an economic downturn – exposing taxpayers once again. This letter agreement between Treasury and FHFA, which allows the Enterprises to retain capital of up to $45 billion combined, is an important milestone on the path to reform."

It's not like $20-odd billion will eliminate the GSEs as a threat to financial stability. Far from it. The shocking fact — to which I owe a hat tip to Isaac Boltansky and his Compass Point colleagues — is that the GSEs could be released from conservatorship with as little capital as that. As the Compass Point analysis put it: "The announcement this morning allows Fannie Mae to retain up to $25B of capital and Freddie Mac up to $20B. Both are above their minimum required core capital levels at 2Q19 of $22.3B and $18.4B, respectively. Based on our earnings forecast, it would take Fannie Mae until 4Q20 or 1Q21 to reach this level from retained earnings and it would take Freddie Mac until 2Q21 to 3Q21."

Specifically, this is how it would work: Later this year, FHFA is expected to finalize its rule for the amount of risk-based capital that the GSEs must hold. This sum is presumably substantially more than the minimum core capital amounts ($22.3 and $18.4 billion) mentioned above. Many people, myself included, assumed that conservatorship would have to continue until this risk-based standard was accumulated. The surprise is that the GSEs could be released from conservatorship (and operate under a consent agreement) until they reached the risk-based capital requirements and would then be deemed "adequately" capitalized.

Fannie Mae's total assets (Q12019) are $3.4 trillion, of which $3.2 trillion represent mortgage loans net of loan losses. Let's focus on those. In a risk-based capital system, the first step is to apply risk weights to the assets. Per Basel III's standardized approach, the risk weight for home mortgages is 35 percent. It is also possible, however, that a firm can use an internal model of risk weights (which Fannie very likely would employ), and such a step might return a value closer to 12 percent. As a result, their risk-weighted mortgage assets could be calculated to be between $1.1 trillion and $391 billion. Now, the capital requirements under Basel III mean that most large international banks end up holding capital of roughly 14 percent of risk-weighted assets. Thus, the capital requirement for Fannie could be in the neighborhood of $160 billion. Under the most generous assumptions it would be as little as $31 billion, which is still nearly 50 percent higher than the minimum required core capital levels. A similar set of considerations apply to Freddie Mac.

The GSE business model has proven itself to be dangerous. Allowing the GSEs to resume operations prior to reaching the level of capital required to reflect the risk they pose is a bad idea by any name and under any consent agreement.

THAT, my friends, is risky business.