



The Daily Dish

The FSOC and the GSEs

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Eakinomics: The FSOC and the GSEs

Friday the Financial Stability Oversight Council (FSOC) released its [review](#) of the secondary mortgage market activities of the housing government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. It was an important moment from a number of perspectives. First, the review was conducted using the “activities-based approach” described in the interpretive guidance on nonbank financial company determinations issued by the Council in December 2019. Critics of the FSOC have stressed that it should move away from a simple examination of entities as the route to designating systemically important financial institutions (SIFIs). This was usually just a “big is bad” sentiment in action; the activities-based approach forces the FSOC to spell out exactly how systemic risk is generated.

Second, the FSOC concluded that the GSEs activities – namely purchasing mortgages for securitization and sale as guaranteed mortgage-backed securities – are a potential source of systemic risk. “The 2008 financial crisis demonstrated that financial stress at the Enterprises could limit their ability to provide reliable liquidity to the secondary market or perform their guarantee and other obligations on their MBS and other liabilities, with significant implications for the national housing finance markets, financial stability, and the broader economy. The Enterprises continue to play a central role in the national housing finance markets—acquiring nearly 50% of newly originated mortgages in both single-family and multifamily markets—and are two of the largest U.S. financial institutions. The Enterprises’ provision of secondary market liquidity generates significant interconnectedness among the Enterprises, banks, non-bank financial institutions, and other counterparties. Moreover, given their similar business models, risks at the Enterprises are highly correlated; if one Enterprise experiences financial distress, the other may as well. If the Enterprises were unable to provide liquidity to the secondary market, other market participants may be unable in the near- or medium-term to provide liquidity at the scale and pricing needed to ensure smooth market functioning and financial intermediation. As a result, any distress at the Enterprises that affected their secondary mortgage market activities, including their ability to perform their guarantee and other obligations on their MBS and other liabilities, could pose a risk to financial stability, if risks are not properly mitigated.”

The key phrase at the end – “if risks are not properly mitigated” – leads to the third important aspect. The FSOC concluded that the recently proposed [GSE capital rule](#) from the Federal Housing Finance Agency (FHFA) was sufficient to mitigate those risks, but a less stringent capital rule was not. This is tantamount to buy-in to the capital rule by other financial regulators and makes it very unlikely that the rule will be revised substantially.

The final aspect of the FSOC decision is that it is wind at the back of those in favor of ending the conservatorship. There is still enough unfinished work – finalizing the capital rule, reworking the GSEs agreement with Treasury, actually raising capital, and so forth – that it does not appear imminent, but the FSOC decision is a step in that direction.