GSE Activity Report

Thursday, July 30, 2020

Liquid Dynamite

Summary

Fannie Mae's and Freddie Mac's 2Q earnings statements reveal for the first time that FHFA on June 17 imposed a new liquidity regime akin in some respects to the banking agencies' LCR and never-finalized NSFR along with various other liquidity and resiliency standards for GSIBs. Combined with FHFA's proposed capital construct, this liquidity regime raises additional challenges to GSE recapitalization. Enhanced GSE liquidity resilience could avert the kind of meltdown that propelled them into conservatorship in 2008 as a result of acute illiquidity and perhaps even make the GSEs less dependent on market assertions of an implicit USG guarantee.

However, as we learned the hard way for banks, lots of HQLAs combined with a tough leverage ratio lead to higher risk-taking on the credit side combined with unwillingness, if not also inability, to serve as market-makers. Given that the GSEs' mission is secondary mortgage market-making, this creates still more dissonance between GSEs as private-sector ventures and GSEs as market stabilizers.

Impact

How damaging this dissonance may prove can only be assessed with more knowledge about what FHFA's new liquidity rules in fact demand. FHFA has said nothing so far about this new standard even though a clear understanding of it not only enhances transparency, but also builds confidence in investor planning to provide the capital needed to hoist the GSEs out of conservatorship.

Fannie's 2Q provides the most details on the new liquidity directive. The new standards are, Fannie says, likely to become effective on September 1 and, while Fannie can meet them, it projects lower net interest income and additional capital costs. Freddie provides less detail on the new rules saying only and correctly that they are tougher than those imposed on banks and that higher funding costs and lower net interest income may well result. Freddie also bemoans changes to its investment portfolio.

According to Fannie, the new liquidity standards have four components:

- a 30-day cash-flow test providing continuing GSE market liquidity along with holding a $10 billion liquidity buffer. This is analogous to the big-bank liquidity coverage ratio (LCR) requiring that outflows can be handled by inflows from certain funding sources and sales of high-quality liquid assets (HQLAs) over a 30-day horizon. Banks do not have an express

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LCR buffer, but most hold well above the 100% inflow/outflow ratio;

- a 365-day ratio ensuring cash flow sufficient for outflows over a one-year horizon as well as under certain stress conditions. This metric – but apparently not the LCR-like one – specifies permissible HQLAs for the GSEs. This construct seems similar to the net stable funding ratio (NSFR) finalized by the Basel Committee but never implemented in the U.S. It may also have elements of the liquidity stress testing demanded of big banks;

- a minimum long-term debt to less-liquid assets ratio. This is in some ways analogous to the big-bank total loss-absorbency capital (TLAC) ratios in the U.S. because, despite its name, the U.S. TLAC rules rely on long-term debt, not the contingent capital authorized under the global rules; and

- an overall requirement that the GSEs fund assets with liabilities with a specified minimum term relative to the term of the asset, whatever any of that may mean.

Fannie does indicate that the TLAC-like ratio defines illiquid assets as those ineligible to be FICC collateral, but whether this applies to any of the other ratios is not made clear. If the LCR/NSFR-like ratios are anything like those governing U.S. banks, then HQLAs are defined in tiers that strongly favor excess reserves (not available to the GSEs) and Treasury obligations. Banks can also hold limited amounts of GSE and FHLB debt, but it seems likely that FHFA may have either barred or limited this still more to limit GSE concentration and wrong-way risk. The larger the holdings of strictly-defined HQLAs, the tougher the GSEs' balance sheets become because, as Freddie implies, portfolio returns will be meager at best.

The biggest U.S. banks are forced to hold about one-third of their balance sheets in HQLAs to comply with the LCR and enhanced liquidity standards including stress tests that may or may not be comparable in at least some ways to the stress scenarios referenced above. This might imply that Fannie and Freddie would need to hold far larger portfolios comprised solely of HQLAs than they do now, but their securitization construct makes the outflow assumptions very different than these are for banks with large on-balance sheet portfolios.

Outlook

As we noted, the FHFA capital proposal has a tougher leverage-ratio construct for Fannie and Freddie. Even without all these HQLAs, it turned out to be the GSEs' binding constraint in 2019. With all these HQLAS, it could prove to be so under most conditions just as proved to be the case for many large banks until the banking agencies replaced the prior stress-test and capital regime with the stress capital buffer (SCB).

Given that several other proposed capital charges are also risk-insensitive, Fannie and Freddie's new capital construct could ensure still greater incentives to risk-based capital arbitrage via guarantees of higher-risk mortgages. As we noted, the complex FHFA proposal does not always capture mortgage risk well, generally doing so more leniently than demanded of banks on grounds that GSE mortgages are less risky than those banks may hold. True enough for now, but later on?

An even greater concern with tough, let alone binding, leverage ratios is aversion to holding any more HQLAs than required to meet all the liquidity rules because the very low returns on HQLAs – check out ten-year Treasuries today – and high LRs make these assets profit gobblers. Big banks thus stayed out of the repo market when it swooned in September of 2019, forcing huge Fed intervention. Would GSEs do the same in a mortgage-market liquidity freeze? They could if freed from conservatorship and under a combined leverage and liquidity framework along the lines suggested in today's 10-Qs.

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