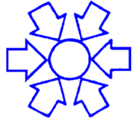 Federal Financial Analytics, Inc.

# MEMORANDUM

**TO:** Federal Financial Analytics Clients

**FROM:** Karen Petrou

**DATE:** July 31, 2020

Yesterday, our report brought to light a new FHFA liquidity standard with the potential to be at least as important to U.S. housing finance as the agency's high-profile capital proposal. As we showed and the *American Banker* today reported, the liquidity rule interacts with the capital proposal in complex and, we conclude, unintended ways. It makes sense for the capital rules to aim for bank-like loss absorbers – mortgage risk is the same risk whether it's on a bank's balance sheet, an MI's, or Fannie and Freddie's. But, funding inflows in and out of the GSEs work very different because GSEs are very different than banks, GSIBs included, when it comes to critical factors such as funding sources, outflow expectations, and the federal safety net. It's possible that FHFA's liquidity rule masters all these differences and thus ensures that Fannie and Freddie could meet mission-critical market needs under stress. However, since FHFA chose to impose these strategy-critical standards in dark of night, we can't tell. What we do know is very worrisome.

Hints about the FHFA liquidity directive come only from brief descriptions in second-quarter GSE earnings statements that securities lawyers doubtless told Fannie and Freddie they need to make public despite FHFA's cone of silence. Freddie largely confines its comment to rueful expectations of adverse earnings impacts; Fannie is more forthcoming, providing a very short description of the directive's four key parts.

As we noted, these suggest a construct akin in broad terms to the big-bank LCR, NSFR, TLAC, and – maybe – enhanced liquidity-risk standards. However, we can't tell whether these commonalities are just in terms of simple factors such as inflow/outflow durations or if critical terms such as "stress" and "market" or "high-quality liquid assets" are the same. Does the new TLAC-like directive mandate new forms of long-term GSE debt akin to those from BHCs deemed by the bank rules to be divorced from TBTF expectations? Which markets must the GSEs ensure? What stresses must be buffered? Indeed, what assets count as high-quality liquid ones (HQLAs)?

Key to the bank liquidity construct and, apparently to FHFA's is matching or even exceeding cash outflows with cash inflows. For banks, inflows come from core deposits, excess reserves, loan repayment, income, and wholesale funding, with cash proceeds from HQLA sales playing a particularly critical role. The rules also expect that all outstanding credit lines extended by banks are drawn down even as all the lines banks could access evaporate and that all securitizations are frozen solid. How does this apply to Fannie and Freddie? Not at all well.

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First, their funding sources are principally debt – debt that is deemed to have an effective USG guarantee that makes it uniquely liquid under stress. Treat this like a core deposit or assume markets freeze as they actually did in mid-March until the Fed stepped in? Unlike core deposits, agency debt has a unique market role as market collateral and, at least sometimes, as a component of the Fed's balance sheet and those of most global central banks. FHFA may intend to ignore the systemic role of agency debt in hopes of market discipline and a more private-sector housing construct, but the GSEs would then need to hold giant HQLA balances or come up with other funding sources to ensure liquidity.

What about outflows? Do GSE liquidity-stress scenarios track those for banks? They could – Fannie and Freddie went into conservatorship in 2008 not because the mortgages they held were unduly risky (although many private MBS were), but because the secondary market shut down. In 2008, markets collapsed; in 2020, the Fed bailed them out, agency MBS very much included. As a result, bank-like outflow assumptions are inappropriate unless FHFA is again seeking a bank-like construct despite the GSEs' agency status. FHFA may want Fannie and Freddie to stand so firm that the Fed would never need to step in ever again, but the trillions involved here are so many that it's hard to forecast what bullet-proof GSEs would be other than Fort Knox.

The reason for this isn't so much the liquidity rules, but how they interact with FHFA's proposed capital construct and most importantly its redesigned leverage ratio (LR). If the GSEs are supposed to stand independent of their USG guarantee for funding inflows and for secondary-market asset absorption, they will need to hold huge balances of HQLAs. These will cost them dearly in terms of capital, reducing earnings and postponing for years – if not decades – the date at which GSEs free from conservatorship could provide both day-to-day secondary-market liquidity and market-making capacity under stress.

As we noted in our report, big-bank balance sheets are about one-third HQLAs due to applicable liquidity rules. The GSEs' current non-mortgage securities portfolios are each about $108 billion. If a third of their books was HQLAs defined only as Treasury obligations and not also their own MBS, their HQLAs would be about $2 trillion. FHFA cannot intend this, but what does it want?

We saw the dangerous confluence of liquidity and leverage rules last year when the repo market shut down – banks stood back due to the post-crisis framework and the Fed threw trillions in to save intra-day liquidity over the course of almost six months. What if something like this happens in agency debt and/or MBS markets? A transparent rulemaking process in which one could answer the questions I've raised above and many others would help ensure we never find out the hard way.