GSE Activity Report

Thursday, September 10, 2020

Greener GSEs?

Summary

As we noted yesterday in our in-depth analysis, a CFTC subcommittee has issued a landmark report laying out an array of climate-change risks it urges policy-makers to prioritize to prevent systemic and sector risks. Fannie and Freddie are among the entities noted with particular alarm, with the paper thus laying out actions FHFA – especially a Democrat-led one – may take on its own or under the directions recently demanded of the federal banking agencies by Senate Democrats. However, if Fannie and Freddie remain in conservatorship, then their climate-change mission will be still more mandatory and immediate.

Impact

The GSEs are described in this report as "government shock absorbers" that, in addition to credit and other risks, take climate risk off lenders' hands. However, the GSEs are said to be exposed to climate and especially to flood risk and unable fully to adjust underwriting standards to mitigate it. Indeed, the report suggests that lenders may intentionally transfer risks, including climate risk, to Fannie and Freddie. CRT of course moves some of this risk from the GSEs into the market, but the CFTC subcommittee worries that risk transferees may not be well equipped to absorb it under stress.

As a result, the report states that taxpayers may ultimately take the fall for prepayment and default risk due to asset-price dislocations resulting from physical risk. A policy priority is thus effective climate-risk measurement, monitoring, and management. In the absence of better controls, GSE risk could be transmitted not only back to taxpayers, but also across the financial system, triggering a still more dangerous adjustment of housing-asset prices.

Outlook

FHFA now has its hands more than full with COVID and the capital rules even if Director Calabria cared to take on climate risk. However, the thrust of this unanimous and bipartisan report will be to press financial regulators next year regardless of the election to ramp up climate-risk controls. With Democrats in charge, the ramp up will be faster and more prescriptive; if Republicans retain the White House but Congress turns blue, force will still be applied to do so. Either way, inside or out of conservatorship, the GSEs will join other U.S. financial institutions under federal control in a new regime of tougher climate disclosures, mandatory risk-management and governance standards, and – over time – stress testing. If the GSEs remain in conservatorship next year, then the they along with

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FHA will come under particularly hard and immediate pressure to use their market clout to demand green-finance policies across the residential and multi-family sectors, assuming a *de facto* regulatory role given the inability of federal agencies directly to reach nonbank originators.

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