



# *GSE Activity Report*

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Tuesday, October 3, 2017

## *Conservatorship Quandary Continues*

### Summary

Mel Watt's appearance today before the Financial Services Committee signals the beginning of House GSE-reform action, but it's the beginning of the beginning with little clear end in sight. That said, the GSEs' exemption from the QM rule and, by inference, FHA's is now taking heavy GOP fire that could result in regulatory change under a Republican head of the CFPB.

### Impact

Some of today's hearing was preoccupied by political questions about Watt's travel arrangements and the glamor of Fannie's new downtown offices. The session was surprisingly light on current events, including the decision Friday to pay over GSE earnings to Treasury. Watt made a strong defense of the need for a capital buffer in his testimony, but also argued that it was Congress' – not his – decision on what to do with the conservatorships. Pressed on whether FHFA alone could build a buffer, Watt was less assertive than earlier this year before Senate Banking, saying now only that he has this authority but that his strong preference is to come to an agreement with the Treasury Department.

The talk of capital did, though, turn to just how much of a cushion would make Fannie and Freddie more resilient. Under questioning, Watt said that something in the range of 3% to 5% might be right given where bank capital requirements are, but he also suggested that GSE capitalization could go lighter since the GSEs risk-share. Of note, the 3%-5% ratio apparently refers to the leverage ratio, not risk-based one; for the largest banks (surely the right comparison to the GSEs), the leverage ratio is 6%. Further, the GSE risk-shares generally put Fannie and Freddie into a first-loss position; bank regulators view this as so risky that the risk-based charge is actually at least 125% higher than the 100 percent risk weighting applied to higher-risk mortgages and 350% higher than the 50% weighting for prudent loans. As noted in a recent [Petrou memo](#), it will take decades for the GSEs to come up even to a 5% ratio, let alone one that takes first-loss tranches into account.

Hensarling has long been critical of expanded GSE activities such as the recent HLTV programs and he also blasted the GSE QM exemption when it was included in the

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CFPB's 2013 rules. Since then, the issue went dormant – until today.

Now, the GOP is back, arguing that high DTI ratios put both the GSEs and private competition at risk. Watt responded that GSE loans aren't necessarily riskier and surely expand credit access – two points to which Republicans were unsympathetic. They were similarly unmoved when Watt said the CFPB plans to get around to reviewing the QM in the next few years.

## Outlook

Will the GOP move legislation to rewrite the QM? We doubt it. Rather, this is flagging an issue that Hensarling plans to make into a cause when Cordray leaves the CFPB. At that point, the QM rule will definitely come in under review far earlier and more scathingly than would be the case under Cordray. Still, a revision that revokes the GSE and FHA exemptions would need to be done through formal rulemaking and thus perhaps take even longer than figuring out what to do with the conservatorships.