GSE Activity Report

Thursday, November 2, 2017

Look, Ma – No Capital!

Summary

We see little of note in the GSEs' earnings – same-old, same-old in that one-time events such as mark-to-market and settlements determine gain or loss. However, same-old, same-old will get all too interesting if one-time events work against the GSEs or, still more worrisome, if credit or liquidity conditions worsen. Capital is on its inexorable slide even as volumes rise – in short, we've very big conservatorships riding very small bikes on a roller-coaster.

Impact

As of September 30, after their dividend payments, both GSEs' capital reserve accounts were $600 million set against $3.3 trillion of assets for Fannie and $2 trillion for Freddie. During the first quarter of next year, the capital reserve accounts drop to zero while their assets will likely be relatively unchanged. Put another way, the largest U.S. banks, which must meet a 6% leverage ratio would have to hold $198 billion against Fannie's assets and $120 billion against Freddie's. We can argue the merits of the 6% leverage ratio for GSIBs – indeed we have. However, the distance between the GSEs and GSIBs is beyond question a very risky proposition.

The counter-argument to this is that the GSEs are now sharing so much credit risk (over 30% of each GSE's guarantee book) as to warrant less capital than the GSIBs. Still, no capital is a stretch and then some. Notably, the very largest banks share a lot of risk that does not offset their 6% leverage requirement and many also hold far higher balances of zero-risk paper than do the GSEs. Fannie and Freddie are not only shrinking their portfolios and thus do not hold the huge books of Treasury and similar obligations against which GSIBs must still post 6% capital, but they are also ineligible to hold excess reserves at the Fed, an asset now amounting to $2.2 trillion held mostly by these same GSIBs. Central-bank deposits are even less risky than cash – against which GSIBs must also post leverage capital – but current rules show no mercy.

These capital rules are among the reasons large banks now rely so much on the GSEs and FHA for mortgage origination, as well as the reason non-banks now dominate GSE originations. Freddie's numbers show a 3% volume hike so far this year and Fannie show a 2.2% increase – nice, if not spectacular, but also still more reason to worry about zero capital ratios.

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Outlook

There obviously will be headlines when the GSEs' capital reserves formally fall to zero next year but nothing like what will happen if either or both make a draw on the Treasury. If the Republican tax plan released today calling for a permanent reduction in corporate taxes from the 35% rate to a 20% rate becomes law, the hit to both GSEs' deferred tax assets will be significant. While Fannie notes that a reduction in deferred tax assets would cause it to take a draw from the Treasury, Freddie remains silent. If the proposed reduction in corporate tax rates is little changed as the bill moves toward the White House, look for GSE reform to become an urgent priority and FHFA's flexibility to allow the GSEs to hold capital to change, and fast.

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