GSE Activity Report

Monday, December 21, 2020

LCR + NSFR + LR = Ouch

Summary

As previously noted, FHFA late last week issued a long-promised proposal implementing LCR- and NSFR-like – but not light – rules for Fannie Mae and Freddie Mac. Although these in many ways resemble existing GSE liquidity guidance, that guidance isn't quantitatively stress-tested nor has it been implemented in concert with meaningful leverage-capital rules. FHFA's final capital standards now include a meaningful and maybe even binding leverage ratio (LR). The more zero RWA, LR-heavy assets at a GSE, the bigger the mandatory LR and this liquidity proposal certainly demands significantly higher HQLA balances.

Impact

Big banks must hold about one-third of their balance sheets in HQLAs to meet their liquidity rules, a requirement that often made the LR the biggest banks' binding ratio until the stress capital buffer sought to straighten that out. Similar standards for the GSEs mean similar HQLAs and thus more capital than currently modelled into FHFA's estimates or most private forecasts.

How much more capital? In sharp contrast to the capital proposals, the liquidity NPR is unaccompanied by any quantative estimates or qualitative forecasts. This is a significant omission and one FHFA will in our view need to remedy in a final rule, if not before, to ensure a clean APA record should anyone choose to challenge the liquidity construct.

As noted, the FHFA proposal is similar to and in some ways tougher than the big-bank liquidity construct. Key details about the banking agencies' liquidity coverage ratio (LCR) may be found here; the in-depth analysis of the net stable funding ratio (NSFR) here. We thus do not provide details on these rules or FHFA's thinking on them, instead laying out key GSE-specific aspects of the liquidity NPR.

In broad terms, the big difference between current GSE liquidity-risk requirements under applicable guidance and the NPR's standards is the addition of stress assumptions which must be met with prefunded liquidity. This is analogous to the LCR and NSFR which for example stipulate full drawdowns of all outstanding credit lines provided by a bank and immediate termination of all lines the bank might otherwise access. However, FHFA's proposal not only requires two additional quantitative liquidity ratios (see below), but also an array of governance, risk-management, and operational standards similar in many respects to the enhanced liquidity rules only required by the banking agencies of the very largest banks. Throughout the NPR, FHFA calls the GSEs systemic and the proposal is clearly aimed at GSIB-style standards along the lines the Fed would surely demand were the GSEs deemed SIFIs by FSOC as the Biden Administration takes over.

The following summarizes strategy-critical points in the complex NPR:

- HQLAs: Reflecting the fact that the GSEs aren't banks and thus don't have like-kind funding, the NPR defines HQLAs in the context of new operational restrictions and without reference to core deposits. It also does not allow any obligation correlated with mortgages (e.g., another GSE's MBS, agency-mortgage repos). Instead, HQLAs are unencumbered cash held at the Fed, certain cleared repos, and a small amount of overnight unsecured deposits with eligible (i.e., large) U.S. banks. Cash inflows from pledged clearing-eligible collateral for certain repos also count as HQLAs for the NSFR-equivalent standard.

- Cash Flows: Cash-flow projections are critical to how these liquidity ratios work – the more cash in, the fewer HQLAs. FHFA defines cash flows with stress in mind – for example, the GSEs must assume failure of the top five nonbank seller-servicers, reduced borrower payments, and no expected proceeds from unsecured debt issuances. Cash outflows must also assume outflows through cash windows or conduits as well as NPL purchases, larger MBS trust buy-outs, and margin pressure. The rule in general treats cash as cash only when it's in hand, not when it's expected; TBA contracts are also treated quite conservatively. The GSEs are also to add their own stress factors (e.g., lower rates that lead to debt calls) into LCR/NSFR compliance.

- Additional Ratios: In addition to the LCR- and NSFR-like standards, the GSEs would be subject to a 120 percent "simple" long-term standard based on the amount of long-term unsecured debt divided by less-liquid assets defined conservatively (e.g., including CMOs). There would also be a sixty percent model-based long-term standard based on unsecured-debt spread duration divided by portfolio-asset spread duration to reduce repricing and fire-sale risk. HQLAs, initial margins, and assets without funding (e.g., certain CRT trusts) do not count for purposes of these ratios. Stockholder equity is treated as a short-term funding source, but views are solicited on this approach.

- Buffers: Although all of the FHFA requirements are to be considered minimums, the LCR also includes a $10 billion add-on above the highest cumulative cash needs each day as calculated in the rule and the NSFR including haircuts and other constraints to provide more of a cushion. However, the NPR then details how buffers could be drawn down under stress. Conversely, the NPR also allows FHFA to tell one or both GSEs they need more liquidity, doing so with a prior non-public notice and comment period.

- Sanctions: The NPR also details how the GSEs are to notify FHFA of liquidity shortfalls and FHFA's actions in such cases (e.g., agreement on buffer draws, required restoration plans, sanctions).

- Reporting: This would be daily to FHFA with key stress scenarios detailed in each filing. The GSEs would also make monthly public reports on their performance on all four liquidity ratios.

Outlook

Many of the NPR's questions seek views on fundamental assumptions such as the restricted HQLA definition. As a result, the final rule's impact could differ markedly from the proposal's even though it seems likely that, under any scenario, GSE leverage-ratio capital requirements will go up substantially

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and the balance between risk-based and leverage ratios will again prove problematic absent further adjustments to the capital ratio or a new approach to stress capital buffers.

Reflecting numerous assertions in the NPR about the GSEs' systemic risk, the liquidity standards would be effective on April 1, 2021.

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