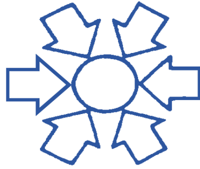

GSE Activity Report

Friday, August 13, 2021

Why Worry?

Summary

FHFA today released both the 2020 and 2021 stress-test results for Fannie and Freddie. Singly and together, the GSEs show formidable resilience and even the potential to build a bit of capital in a severely-adverse scenario. Without access to the FHFA or GSE models, we cannot tell the extent to which this takes into account the looming risks as forbearance ends, but we have to assume it does. If so, the GSEs should continue to accumulate capital ahead of the time when someone finally thinks about what to do with it.

Impact

Key to the 2021 results is the fact that the GSEs in 2021 would still have had positive income after absolutely everything went wrong. Indeed, the income levels are respectable, with Fannie clocking a 0.94% ROA and Freddie reporting 0.77%. The GSEs' exposure to credit loss is also impressive; Fannie's loss is 0.39% of assets and Freddie's is 0.22%. However, there is wide divergence in mark-to-market results, with Fannie breaking even and Freddie gaining $5.3 billion.

A notable change in 2021 was the inclusion of MIs among the counterparties the GSEs need to stress. However, the test is only for default of the largest GSE counterparty. It might encompass a large MI if a large nonbank doesn't trump it (as we think likely). Lumping global market and counterparty risk together shows both GSEs in negative territory, but this is thus well within the range of loss that can be readily absorbed thanks to continuing income and growing capital buffer.

We would note, however, that FHFA's test appears to continue to allow for the calculation of credit losses after taking MI into account; the Fed dislikes monoline credit insurance and thus doesn't permit this. Using only the largest counterparty in the test also doesn't address banking-industry concerns that FHFA otherwise discounts risk possibly inherent in the nonbank servicer sector.

As always, most of the test scenarios are akin to the Fed's comparable stress test. However, FHFA takes a dimmer view of inflation than the Fed, projecting a test-end 2.25% rather than the Fed's 1.5%. Conversely, FHFA is gentler on the commercial loss front than the Fed, estimating only a 35% price drop rather than the Fed's 40% (a difference likely justified by the fact that the GSEs' commercial real estate is almost exclusively multifamily and that of the banks includes of course a lot else that is often a good deal riskier these days).

Outlook

A cautionary note: the test measures only resilience to credit and market risk, not also to the liquidity risk that felled Fannie and Freddie in 2008. Then, the GSEs were naked to the storm; now, they've a

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very comfy security blanket.

In the event of another dash for cash, the GSEs would be as hard pressed now as then but for the fact – we think it's a fact – that the Fed would instantly start buying agency MBS again even if tapering at a future date included an end to current purchases. Further, the Fed would also step in to buy debt if needed. Fannie and Freddie on their own also have access to the ONRRP and, under stress, we would guess to the Fed's stand-by repo facility. All of this raises moral hazard issues, but these backstops more than reinforce the GSEs' effective guarantee.

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