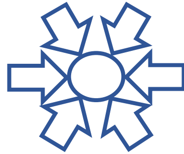

# GSE Activity Report

**Friday, August 12, 2022**

# Testing for What, Why?

## Summary

FHFA, Fannie, and Freddie yesterday released the results of FHFA's latest stress test, focusing on the severely-adverse scenario in order – or so FHFA says – to push the GSEs to the limit. This the test does insofar as the GSEs' combined CET1 capital shortfall is as much as $159 billion. However, aspects of FHFA's test – e.g., falling inflation over 2022 and 2023 and rising house prices – are likely to be more than a bit off. The conservatorship of course insulates the GSEs from any of the consequences that would befall a big bank with even a fraction of these capital shortfalls, but it does cast doubt on when these conservatorships could end without a large line of Treasury credit still in place to back them up.

## Analysis

Under the severely-adverse scenario, Freddie stays solvent in terms of income, although Fannie loses $6.3 billion after taking its valuation allowance into account. However, we question these numbers as guides to what might happen to Fannie and Freddie under the kind of stress more likely under current market conditions because FHFA's scenarios include expectations such as an annualized 3Q/22 CPI of 1.25% rising only to 1.5% at the end of the planning horizon even though it somewhat mysteriously starts with a CPI of 8.25% at the end of 2021. FHFA also says that short-term Treasury rates will remain at about zero across the horizon while the ten-year rate is said actually to fall and the yield curve grows ever sharper rather than inverting as is often the case under the kind of macro scenario forecast for GDP and employment. These macro forecasts are roughly similar to the Fed's 2022 CCAR exercise as is FHFA's house-price decline. However, the Fed projects a CRE drop of 40% and FHFA hits the GSEs with only a 35% loss. In the real world, these both seem extreme under current markets even if these become hard-pressed, but the difference does make FHFA's test more generous to the GSEs given far higher multi-family housing exposures than found in any of the large banks.

## Outlook

Do these stress-test results have any market or policy impact? In short, no.

In 2019, banks complained about FHFA's stress tests on not-unreasonable grounds that FHFA had summarily and surely incorrectly assumed that bank-portfolio mortgages were eight times riskier than those backed by the GSEs, but neither the Fed nor FHFA changed its views and nothing much happened in terms of either market reaction or policy response. The 2022 tests might have some impact in terms of GSE credit enhancement decisions since the new tests capture MIs and reinsurers as counterparties for certain scenarios, thus theoretically increasing capital requirements related to loan-level or CRT exposures to the largest firms in these sectors. But, what binds the GSEs in terms of competitiveness vis-a-vis banks is how their credit exposures affect regulatory capital on the road to compliance with these ratios, not as ratios affect resilience under these stress tests.

---

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com

© 2022 Federal Financial Analytics. All Rights Reserved.

When the GSEs finally triumph over these minimums and presumably exit conservatorship, then stress testing designed to judge capital-distribution capacity might make a difference. Until then, it doesn't.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com

© 2022 Federal Financial Analytics. All Rights Reserved.