A Consequential Proposal

The FHFA’s GSE Capital Requirement

Donald H. Layton, Senior Industry Fellow

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JOINT CENTER FOR HOUSING STUDIES
OF HARVARD UNIVERSITY

Setting the Stage

Minimum regulatory capital requirements

- Pre-2008 history: low capital requirements by former specialty mortgage regulators

- Post-2008 banking system capital reform
  - o Higher!
  - o Three regimes: (1) Leverage ratio
    (2) Basle risk-weighted
    (3) New: CCAR-stress test plus going-concern buffer

- Driven primarily by technocratic policy, secondarily by politics

Setting the Stage

GSE reform while in conservatorship (selected items)

- Elimination of unlimited subsidized investment portfolios
- “Notional” regulatory capital requirement: Conservatorship Capital Framework (CCF)
- Development & implementation of credit risk transfer (CRT)

FHFA’s Proposal

FHFA’s Proposal – Key Terms

- Leverage ratio: 4% of assets = $243B
  - Designed to be cyclically binding (applicable now)
- Risk-based (largely Basle-style) = $234B
  - Based on CCF: $135B (max of three calculations) plus $99B discretionary buffers
  - Usage of look-up tables, floors, maximum-of’s, etc.
  - Offsets to significantly pro-cyclical economics
- Missing: CCAR–type “stress loss + going-concern buffer” approach

FHFA's Proposal – Major Structural Concerns

- Complexity is very high
- Cyclically-binding leverage ratio at odds with Basle doctrine
- Problematic risk transfer policy bias: anti-CRT (while inconsistently pro-PMI)
- "Avoiding restrictions on distributions/compensation" clause is not meaningful relief
  - Additional management buffer also needed, in practice, to avoid this consequence

Policy Analysis

Framework for Policy Analysis

- Question 1: Capital at right level? [i.e. macro]
- Question 2: Distorts proper risk-reward decision-making? [i.e. micro]
- Question 3: Systemic risk materially increased or decreased?
- Question 4: Consequential impacts on housing/housing finance?

Capital at right level?

FHFA proposal: 2018 original at ~ $137B level, 2020 current at ~ $243B level

Sense check #1: Reasonableness of implied going-concern buffer (G-CB)

Capital required	$137B	$243B
- max DFAST loss	$ -43B	$ -43B
= Implied G-CB	$ 94B	$200B
or		
X times loss	2.2X	4.7X
But: "without DTA loss"	6.6X	12.5X

Conclusion: $150B - $170B range reasonable, $240B range not

Capital at right level?

Sense check #2: Is leverage ratio "SIFI-consistent" (i.e. same capital for same risk)?

- Proposed ratio: 80% (GSE 4% versus bank 5%)

- Consider:
    - o Liquidity risk: GSEs transfer > 90% via MBS, banks nil
    - o Interest rate risk: GSEs transfer > 90% via MBS, banks nil
    - o Credit risk: GSEs transfer > 40% via CRT (incrementally > 70%), banks nil

Conclusion: 80% ratio well above SIFI-consistent

- o 40% - 50% range more reasonable (~ 2% - 2.5% of assets, $122B - $152B)

Distorts proper risk-reward decision-making?

- When leverage ratio binding: **well-known distortion of decision-making**
  - Pro: high-risk assets
  - Con: CRT transactions

- When leverage ratio not binding:
  - Probable distortions due to judgmental buffers/floors/maximum-of's
  - Unpredictable impact

- Conclusion: Major weakness, especially when leverage ratio binding

Systemic risk materially increased or decreased?

- Background: Congressional charters make GSEs mortgage monolines
  - o Extreme risk concentration a major systemic financial weakness

- GSE reform solution: CRT to *diversified* investors
  - o Vision: GSEs mainly “risk pass-through” entities via MBS and CRT
  - o FHFA capital proposal reverses this
    - ▪ Binding leverage ratio eliminates CRT via false economics
    - ▪ Anti-CRT bias additionally erodes economics

- Implied FHFA vision: Reconcentrate credit risk in GSEs
  - o High capital to address resulting systemic risk
  - o A costly inefficiency!

- <u>Conclusion</u>: Materially increased systemic risk, offset by expensive over-capitalization

Consequential impacts on housing/housing finance?

- Major impact on cost (g-fee) and mortgage credit availability?
  - Yes: g-fees up est. 20%+; credit availability down

- Major increase in taxpayer risk via FHA?
  - Yes: likely significant

- Return to GSE systemic risk concentration?
  - Yes: equivalent to est. $3T eventually

Consequential impacts on housing/housing finance?

- Reduced LMI economic security, esp. minorities?
  - Yes: But offset by any FHA take-up

- Mortgage origination to fewer/larger firms?
  - Yes: GSEs have 1000+, FHA/VA only 400+

- **And**: Impact on raising capital to exit conservatorship?
  - Yes: Negative, maybe material
  - Why: Reduced ROE, market share shrinkage, re-concentrating risk

Q&A