A Consequential Proposal

The FHFA's GSE Capital Requirement

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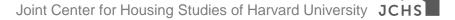


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Setting the Stage

Minimum regulatory capital requirements

- Pre-2008 history: low capital requirements by former specialty mortgage regulators
- Post-2008 banking system capital reform
 o Higher!
 - 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
- <u>max</u> DFAST loss	\$ - <u>43B</u>	<u>\$-43B</u>
= 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:
 - Liquidity risk: GSEs transfer > 90% via MBS, banks nil
 - Interest rate risk: GSEs transfer > 90% via MBS, banks nil
 - 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: <u>well-known distortion of decision-making</u>
 o Pro: high-risk assets
 - Con: CRT transactions
- When leverage ratio not binding:
 o Probable distortions due to judgmental buffers/floors/maximum-of's
 - o Unpredictable impact
- <u>Conclusion</u>: Major weakness, especially when leverage ratio binding

Systemic risk materially increased or decreased?

- Background: Congressional charters make GSEs mortgage monolines
 Extreme risk concentration a major systemic financial weakness
- GSE reform solution: CRT to *diversified* investors

 Vision: GSEs mainly "risk pass-through" entities via MBS and CRT
 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

 High capital to address resulting systemic risk
 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?
 o Yes: g-fees up est. 20%+; credit availability down
- Major increase in taxpayer risk via FHA?
 o Yes: likely significant
- Return to GSE systemic risk concentration?
 o Yes: equivalent to est. \$3T eventually

Consequential impacts on housing/housing finance?

- Reduced LMI economic security, esp. minorities?
 o Yes: But offset by any FHA take-up
- Mortgage origination to fewer/larger firms?
 o Yes: GSEs have 1000+, FHA/VA only 400+
- <u>And</u>: Impact on raising capital to exit conservatorship?

 Yes: Negative, maybe material
 Why: Reduced ROE, market share shrinkage, re-concentrating risk

