The Daily Dish

Fantasy Capital Requirements

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Eakinomics: Fantasy Capital Requirements

I have a rich fantasy life. I just try not to talk about it in public. In contrast, your Federal Housing Finance Agency (FHFA) has requested comments on a proposed capital rule for the housing government sponsored enterprises (GSEs) Fannie Mae ("Fannie") and Freddie Mac ("Freddie"). Recall that capital requirements such as leverage ratios or risk-weighted capital are government regulations applied to private institutions to ensure that they operate in a safe and sound manner and maintain sufficient capital in times of crisis. They are a boring, if essential, part of financial services policy.

The FHFA has the authority to regulate the capital rules that apply to Fannie and Freddie, no question about it. Right now, however, Fannie and Freddie are in conservatorship because they were dually exposed during the housing crisis: (1) They guaranteed billions of poorly underwritten mortgages against default, and (2) They ran enormous, monoline hedge funds exposed to housing risk. When the bubble burst, the house of cards came crashing down and the taxpayer stepped in to pick up the pieces — and the tab.

Now it is proposed that the minimum leverage ratio would be either capital equal to 2.5 percent of total assets or capital equal to 1.5 percent of trust assets and 4 percent of non-trust assets.

BUT, this assumes that the GSEs are suddenly, and somehow, private entities subject to capital requirements. They are not. They are de facto agencies of the government (indeed, the Congressional Budget Office has consolidated their activities into the federal budget) and nobody — that is, nobody — has articulated a path out of conservatorship that includes 218 votes in the House, 60 votes in the Senate, and the signature of the president of the United States. Unless and until there is a policy pathway to return the GSEs to private ownership, this is fantasy rulemaking. (A more dignified version of this argument by Thomas Wade and myself can be found here.)

Even if a route from conservatorship could be satisfactorily defined, it is important to note that the path to private ownership contains some significant hurdles. For example, the moment the GSEs would be released from conservatorship they would be Systemically Important Financial Institutions (SIFIs), and subject to their own specific capital regime. It would be policy malpractice for the Financial Stability Oversight Council (FSOC) to not say so. Instantly, the capital requirements would be roughly double those of the other non-SIFIs and far above those proposed by the FHFA in this capital rule.

Which is just a long way of saying that it is fun to write rules and we AAF folks love commenting on them. But this is a fruitless exercise. Ten years after the crisis, the GSEs are no closer to becoming privatized entities. Even if they were, it is not clear what they would look like, and why the SIFI requirements of FSOC would not apply. Time would be better spent getting Congress to legislate a future for these agencies that removes the conservatorship protection and gets the taxpayer off the hook.