The Value/Cost of a Government Guarantee

The federal government explicitly guarantees things like the FHA and deposits in FDIC insured banks. We can think of these guarantees coming at a cost to taxpayers that becomes effective when there is a claim against the guarantee (e.g., a bailout). The value of a government guarantee is some measure of the distribution of potential payouts to claims of the guaranteed entity.

Currently, in the debate about the FHFA's proposed Enterprise Capital Rules, some want to eliminate the implicit government guarantee due to a desire to eliminate the cost of the guarantee. Others want to make the guarantee explicit. The explicit guarantee side seems to have at least two motivations. One is a desire to maintain the subsidy from the taxpayers to the mortgage business. Another is that the guarantee is so embedded in the institutions of the US mortgage markets that there is a concern for how it would operate without some form of guarantee. For example, many bank capital rules enshrine specific properties to government-guaranteed entities. Another example is that if the credit ratings firms were to look at the enterprises as corporates, their ratings might well be AA rather than agency and what would that mean for agency RMBS' HQLA status in bank capital rules.

If we look at the enterprise capital rules as a way of controlling or minimizing the cost/value of a government guarantee, this new paradigm could help us think more clearly about the debate on guarantees. If there is a continuum of cost/value from zero to trillions, then this is different from either on or off. If an enterprise is required to hold $1 trillion in reserves for each mortgage, then the cost of a guarantee is indistinguishable from zero, so who cares about a guarantee. If there are no capital rules and an enterprise has trillions in liabilities with only a single dollar in reserves, then the cost of a guarantee is so high that no one should favor such a guarantee.

In the building of Enterprise Capital Rules, one of the questions should be where between these two extremes is the cost of the guarantee sufficiently small that the government is willing to bear that cost. In Don Layton's June 30, 2020, JCHSHU presentation, "A Consequential Proposal: The FHFA's GSE Capital Requirement" page 9, he discusses whether the capital requirements of the proposed rules are from a macro-level at an appropriate level. His conclusion is that capital in the range of $150-170B would be sufficient for the enterprises and that the FHFA's proposed rule's capital of $240B was not reasonable.

If we re-cast Layton's analysis in terms of the value of the guarantee, then obviously he is saying that for his tastes when the amount of required capital is in the range of $150-170B, then the cost of the guarantee is sufficiently small that the government should not mind this level. On the other hand, the FHFA proposal would require $240B to reduce the cost of the guarantee to a small enough number that they would be willing to bear the costs.

Given the value/cost of the guarantee paradigm, it may be that we should modify the proposed capital rule to contain a "guarantee test" that an enterprise must pass to maintain its government guarantee. This guarantee test would allow the enterprises to choose whether or not to maintain

sufficient capital to keep their government guarantee or reduce their capital requirements and go without a government guarantee.

In a subsequent article, we plan to suggest a guarantee test to add to the proposed capital rule.