FHFA Pushes Forward With Fannie/Freddie Conservatorship Exit

By: Jann Swanson | Thu, May 21 2020, 10:13 AM

Maybe all of the talk about ending the GSE's long term incarceration in conservatorship is **more than talk this time.** Earlier this week both Freddie Mac and Fannie Mae announced they would be issuing Requests for Proposals (RFPs) seeking to hire financial advisors to that end. Then, late Wednesday, the Federal Housing Finance Agency (FHFA), the GSE conservator, said it was seeking comments on proposed revisions to its own 2018 proposal to establish a new regulator **capital framework for the two companies.** FHFA said the changes to its proposal "ensure each [GSE's] safety and soundness and its ability to fulfill its statutory mission across the economic cycle, in particular during periods of financial stress. The re-proposal is also a critical step toward responsibly ending the conservatorships."

FHFA Director Mark Calabria, referencing the current COVID-19 pandemic, said "This national health crisis has affirmed the importance of the [GSE's] mission to serve the American housing market during good times and bad. When credit dries up, **low- and moderate-income households are hurt most.** We must chart a course for the [GSEs] toward a sound capital footing so they can help all Americans in times of stress. More capital means a stronger foundation on which to weather crises. The time to act is now."

A 1992 Act regarding the GSEs' safety and soundness prescribed both minimum leverage capital and a highly prescriptive risk-based capital requirement. The Housing and Economic Recovery Act of 2008 (HERA), which amended the 1992 act, gave FHFA greater authority to determine the capital standards for the Enterprises.

FHFA said it is asking for comments as it has begun the process to end the conservatorships. This is a policy change since the 2018 proposal was drafted and there was an assumption that the conservatorship could endure indefinitely. This may have informed the comments and perhaps even the decision to comment at all. FHFA proposes to increase the quantity and quality of regulatory capital to ensure each GSE can provide stability and assistance of the secondary market, especially during periods of financial stress. It is also proposing changes to mitigate the pro-cyclicality

The proposed rule maintains at its core the mortgage-risk sensitive capital framework of the 2018 proposal, backstopped by a leverage ratio requirement, with enhancements in four key components:

1. **Quality of Capital** - The quality of regulator capital includes supplemental requirements based on the U.S. banking framework's definitions of capital. These should help mitigate the weaknesses in the GSEs' requirements that became evident in the 2008 financial crisis.

2. **Quantity of Capital** - Enhancements to strengthens the quantity of regulatory capital include:

- Ensuring that levels of risk-based capital for single-family and multifamily mortgage exposures are subject to a **prudent 15 percent risk weight floor.**
- Additional refinements that ensure post-capital risk transfer (CRT) capital requirements are prudent and reflect the credit risk of the exposures retained, while still providing meaningful capital relief for CRT.
- A set of capital buffers that help ensure the GSE's remain viable going concerns and promote stability in the secondary market during a period of financial stress.
- Determination of operational risk capital using the U.S. banking framework's advanced measurement approach, subject to a floor equal to 0.15 percent of the GSEs' adjusted total assets. **This is an increase from the 0.08 percent requirement in the 2018 proposal.** By comparison, of the U.S. bank holding companies with at least $500 billion in total assets at the end of 2019, the smallest operational risk capital requirement was 0.69 percent of that organization's total leverage exposure.
- A minimum leverage requirement of 2.5 percent of a GSE's adjusted total assets, with an additional leverage buffer amount of 1.5 percent of adjusted total assets, intended to serve as a risk-insensitive credible backstop to risk-based measures that are subject to significant model and other risks.

3. **Addressing Pro-cyclicality** - The proposed rule includes the following key changes to address concerns with the significant pro-cyclicality of the aggregate capital requirements of the 2018 proposal:

- The proposed rule's risk-based and leverage capital buffer amounts can be drawn down in a period of financial stress **and then rebuilt over time as economic conditions improve.** These buffers include requirements such as restricting capital distributions such as dividends when capital falls below prescribed limits.
- The proposed rule retains the 2018 proposal's approach to using updated home values to establish the mark-to-market loan-to-value ratio (MTMLTV) of single-family mortgage exposures and their associated risk-weighted asset requirement. However, the use

of MTMLTV through the house price cycle had the potential to cause significant variability and uncertainty in capital requirements, resulting in potentially too little capital at the peak of the cycle while likely necessitating a substantial capital cushion in anticipation of substantially higher capital requirements at the trough. The proposed rule includes a new, countercyclical adjustment to MTMLTV to provide significantly more stability and predictability throughout the cycle while promoting safety and soundness.

- There are additional refinements, such as changes to the base risk weight grids and risk multipliers, **that result in more stable and manageable capital requirements and buffers.**

4. **Advanced Approaches** - The proposed rule includes requirements for the GSEs to assess their own credit, market, and operational risks. They must take responsibility for measuring and managing the risks they take and hold sufficient capital to stand behind those risks. Accordingly, FHFA's standardized capital requirements, set largely through various grids, multipliers, and other formulas, should serve as a safety and soundness backstop to the advanced approaches.

The comment period will extend for 60 days after the proposal is published in the *Federal Register*. A link to the proposal is available at https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Releases-Re-Proposed-Capital-Rule-for-the-Enterprises.aspx

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