Insight

Credit Risk Transfers and the Proposed GSE Capital Rule

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Executive Summary

- The Federal Finance Housing Agency (FHFA) has for the first time in a decade aggressively pursued a path toward releasing the government-sponsored enterprises (GSEs) from conservatorship, and one of the integral steps in this process is a rule that would govern the capital the GSEs would be required to hold after exiting conservatorship.
- While the proposed rule is a thoughtful and nuanced view of GSE capital, and has been broadly supported by industry and policymakers, the rule appears to disincentivize the GSEs from issuing credit risk transfers (CRTs), the primary tool by which the GSEs have transferred credit risk from the taxpayer to private industry.
- CRTs represent one of the few available and most effective tools the housing market has for reducing the risk it poses to the economy: CRTs decrease the risk borne by the federal government, improve systemic stability, have created a highly liquid secondary market, and have improved the quality and access consumers have to mortgages.
- The FHFA appears to intend to finalize the capital rule in short order, but before it does so, it should revisit the proposed treatment of CRTs to avoid unnecessary damage.

Introduction

In May 2020, the Federal Housing Finance Agency (FHFA) issued a new capital rule that would govern the housing finance government-sponsored enterprises, Fannie Mae and Freddie Mac, when they come out of conservatorship. American Action Forum (AAF) experts have written at length on the need for large-scale housing finance reform and the need to end the conservatorship of the GSEs. Higher capital requirements are an essential part of ensuring that the GSEs do not pose the same danger to the U.S. and global economy that they did in the 2007-08 financial crisis.

Nevertheless, some have raised concerns that the rule, as proposed, would undermine one of the only ways that the GSEs are reducing the risk they pose to the federal government and taxpayers. In the decade since the GSEs became public wards, the credit risk transfer (CRT) program represents the only positive step limiting the risk of the U.S. government and the taxpayer to the hazards posed by the GSEs. This piece considers the ramifications of the proposed GSE enterprise capital rule on CRTs and concerns that the rule as structured would diminish the role of the CRTs.

Context: The Proposed Capital Rule

In 2018, the FHFA proposed a rule setting out capital requirements for GSEs, 10 years after the Housing and Economic Recovery Act (HERA) introduced safety and soundness regulations requiring the FHFA director to advance a risk-based capital framework for the enterprises. The proposed rule was largely considered a thought

exercise (AAF experts called it an exercise in "fantasy rulemaking") due to the fact that these capital requirements would only come into effect after the GSEs were released from conservatorship, considered an unlikely notion at the time.

GSE reform has, however, come quite a distance since, largely due to the efforts of FHFA Director Mark Calabria, who has succeeded in reducing the leverage ratio of the GSEs by 75 percent and limiting the GSEs' footprint by eliminating some pilot programs. Despite these successes, Director Calabria has been clear that his primary focus has been the GSEs' capital; to his mind, a well-capitalized GSE out of conservatorship poses limited risks to the economy. To this end, the FHFA announced in November 2019 that it would be re-proposing the entire 2018 capital rule; the re-proposed rule, modifying the 2018 rule, was announced after some delay in late May 2020. (For a detailed analysis of the re-proposed rule, see here).

At its core, the 2018 capital rule proposal would have required the GSEs to hold in capital the higher of either a minimum leverage ratio or a risk-based capital requirement. The re-proposed 2020 rule is largely similar at least in spirit, retaining this dual minimum leverage and risk-based capital requirement. The minimum leverage requirement appears to be the more onerous, and therefore more likely to be binding, requirement in that it would require the GSEs to hold capital equal to 4 percent of adjusted total assets. The 2020 rule also includes a variety of additional capital buffers that would be applied to the GSEs. The addition of these stress capital buffers, adopted from regulatory requirements in banking, represents a far more thoughtful and nuanced take on the capital requirements of what would be financial titans if released from conservatorship than the requirements included in the original proposal. (For a primer on bank capital requirements, see here.) Further, these buffers address a key criticism of the 2018 proposal – that GSE capital requirements would be unintentionally procyclical. Providing these new supplementary buffers, most notably the countercyclical buffer, provides the GSEs with funds in time of need to provide a countercyclical force to the market as required.

Although it is heartening to see the capital buffers used in the banking world applied to the hypothetical privatized GSEs, the comprehensive capital requirement is still lower than it would be if the GSEs were banks. A hypothetical $240 billion of private capital standing in front of the GSEs in the event of crisis would of course be reassuring, but would it be enough to stave off a second collapse? Would the GSEs remain too big to fail?

The Punitive Treatment of CRTs

Recent months have seen increased concern in industry regarding another serious implication of the proposed rule – that the rule as currently drafted appears to disincentivize CRTs.

The proposed capital rule represents two separate assaults on the viability of CRTs: first by making CRTs "count" for less when calculating a risk-based capital requirement, and second by subordinating the risk-based capital requirement entirely.

The proposed rule contains new overlapping provisions that accumulate to severely penalize the capital credit given to CRTs when performing a risk-based capital calculation. The application of new rules – in particular a 10 percent risk-weight floor assigned to senior percent tranches of retained exposures (that is, the portion of credit with the least risk) appears redundant with other effectiveness adjustments proposed. The net effect is to reduce credit for CRTs by over half from the previously proposed rule.

It is clear that by reducing so severely the capital charge applied to CRTs, the GSEs would be disincentivized from issuing further CRT bonds. But the potential problem might be more fundamental than that – not merely

reducing the capital charge of CRTs but rendering them essentially irrelevant. As noted above, the minimum leverage requirement as drafted appears to be the more onerous requirement, and only the higher bar applies. It thus seems likely that it would be the leverage test that would determine the GSEs' capital requirement, and the leverage requirement is risk-insensitive, i.e., it is not based on any assessment of risk at all. Rather than serve as a "backstop" to a well-calibrated capital requirement based on calculations as to the actual risk the GSEs pose, the leverage ratio would simply supplant that calculation, becoming the capital requirement itself.

The potential problems this regulatory structure could cause go beyond devaluing the CRT framework but impact the entire GSE business strategy. As noted by Federal Reserve Board Vice Chairman for Supervision Randal Quarles, "a leverage requirement that is too high favors high-risk activities and disincentivizes low-risk activities." Far from simply devaluing CRTs and pushing the GSEs away from their issuance, the capital rule as proposed could result in a major shift in the GSEs' business models, driving them toward the riskiest activities that put the greatest strain on financial stability. This fear was articulated by House Republicans (in addition to a wide variety of responses by a number of interest groups in direct response to the invitation to comment) in a letter to Director Calabria noting how vital the CRT market is to the overall health of the housing finance system.

Next Steps

The period for public comment on the proposed GSE capital rule closed August 31. Although the FHFA has not officially confirmed a timeline for next steps, it is widely believed that the FHFA will finalize the rule prior to the end of 2020, before shifting focus to amending the preferred stock purchase agreements.

The proposed capital rule is an immensely complex document, fittingly, given the complexity of the housing finance market and CRT mechanisms. It is not obvious that the FHFA *intended* to disincentivize the GSEs from employing CRTs – to do so would be contrary to both common sense and the instructions of Treasury, which in its housing finance reform plan instructed the FHFA to pursue capital relief via the mechanisms of CRTs. Whatever the FHFA's intent, the capital rule as drafted, if finalized, would strongly disincentivize the GSEs from issuing CRTs, a move that would concentrate risk at the GSEs, increasing rather than decreasing the systemic risk of the GSEs to financial stability. It can only be hoped that the FHFA will see its error and reverse its proposed treatment of CRTS rather than proceed with housing finance reform at whatever cost.