Insight

FHFA Releases Proposed GSE Capital Rule

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Executive Summary

- The Federal Housing Finance Agency (FHFA) has re-proposed a 2018 rule dictating the capital requirements for Fannie Mae and Freddie Mac, the two housing finance government-sponsored enterprises (GSEs), were they to be released from conservatorship.
- The 2020 proposed rule would require Fannie and Freddie to hold a combined $244 billion in capital, far higher than the combined $23.5 billion they currently hold, and would add a significant number of additional capital buffers borrowed liberally from banking regulation.
- The rule remains predicated on a hypothetical, but the $244 billion should be considered the minimum the FHFA views as required prior to the GSEs exiting conservatorship.

Introduction

In 2018 the Federal Housing Finance Agency (FHFA) proposed a rule setting out capital requirements for the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, 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 (American Action Forum 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.

This analysis sets out what is in the 2020 capital rule, how it differs from the 2018 rule, advantages and disadvantages of the proposal, and the path forward for the GSEs.

The 2018 Capital Rule

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.

These requirements spurred considerable debate over what is simultaneously the most fundamental and most complicated aspect of any capital requirement – where to set the levels. Set the requirements too low, and of course the GSEs would not be adequately capitalized in a crisis; too high, however, and the cost of capital, along with the cost of mortgages, would significantly increase. A risk-based capital requirement is a complicated proposition given the inability to apply a sensible risk-weighting to assets held by government-backed institutions. On the other side there is the minimum leverage requirement, which would have required 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. A 2.5 percent minimum leverage ratio appears low by comparison to the 5 percent minimum typically applied to community banks, which have fundamentally less risky business models, let alone the capital requirements that apply to the largest banks, ranging from 12 to 18 percent. Significant legislative efforts in Congress (both the Johnson-Crapo initiative and the Corker-Warner bill) fixed on 10 percent as being the appropriate gauge. How then to justify 2.5 percent?

The 2020 Capital Rule

Despite the FHFA re-proposing the 2018 capital rule, and in so doing making significant changes, the 2020 rule is largely similar at least in spirit, retaining a 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 4 percent in adjusted total assets. As of September 2019, the GSEs held a combined $6.1 trillion in assets. Using this as a rough guide, the GSEs would have to hold – at minimum – a combined $244 billion in capital. The two together currently hold about $23.5 billion.

The 2020 capital rule does not simply represent a step up in the core capital requirement. The 2020 rule also includes a variety of additional capital buffers common to the banking world that would be applied to the GSEs. (For a primer on bank capital requirements, see here.) The minimum leverage ratio assessment contains a new requirement that 2.5 percent of adjusted total assets be Tier 1 capital, the safest and most "perfect" form of bank capital. The risk-based capital requirement, in addition to requiring 8 percent of total risk-weighted assets (RWAs), applies a number of other capital buffers, including a stress capital buffer, a stability capital buffer, and a countercyclical capital buffer. These buffers would increase the risk-based capital assessment by about $100 billion from the 2018 capital rule proposal. These additional capital buffers are supplementary, however, and the 2020 proposal suggests that instead of necessarily being factored into the capital calculation and required of the GSEs ab initio, the FHFA might use this higher requirement to determine whether Fannie and Freddie would be fit to, for example, make dividends or provide discretionary bonuses.

Further Analysis

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. 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.

The comprehensive capital requirement is higher than the market expected. Requiring the GSEs to increase their capital reserves by a factor of 10 is a considerable ask, even without the additional new Tier 1 requirements. Not only will this take time, during which the GSEs will presumably remain in conservatorship, but it will be difficult to attract outside investment. Further, a capital requirement on the higher side must necessarily impact mortgage pricing and availability.

Despite there being disadvantages to a higher capital requirement, significant concern also remains that the proposed capital requirement remains too low. Under Director Calabria the GSE's leverage ratio has dropped from 1,000 to 1, to 500 to 1, to 250 to 1. By contrast, the average bank is leveraged at a ratio of about 12 to 1. 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 if they 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?

In addition, two significant unknowns remain. First, there remains a risk that the FHFA could seek to release the GSEs prior to having obtained a desired level of capitalization under a consent order. This proposal is silent as to this possibility, but the high core capital requirement and Director Calabria's desire to get the GSEs out of conservatorship as quickly as possible renders this a not-unlikely result. Allowing the GSEs to resume operations prior to identified capital requirements would be a risky proposition. Second, common sense would seem to dictate that two such enormous institutions would have to be deemed "systemically important" and therefore fall under the purview of the Financial Stability Oversight Council (FSOC). FSOC would under its own mandate apply capital requirements to Fannie and Freddie, and if the banking experience is at all analogous, these requirements would be higher than those set by the existing federal regulator – although that is a problem for the GSEs out of conservatorship. The capital rule should be considered less as a tool for regulating and supervising the GSEs in this hypothetical but more as a goal for assessing the appropriate amount of capital required before triggering that release.

The Path Forward

The proposed capital rule is yet to be published in the Federal Register but will have a 60-day comment period attached. This timeline, however, should not be considered set in stone given that the previous proposed rule comment period was extended by two months in the light of protest that 60 days were not sufficient. Likewise, this proposal may receive some complaint given the proposed moratorium on non-coronavirus related rulemaking, demanded by, among others, Ranking Member Sherrod Brown of the U.S. Senate Committee on Banking, Housing, and Urban Affairs.

Despite this, it seems that the likely intent of the FHFA is to finalize the rule in 2020 and begin the process of raising the required capital in 2021.

Conclusions

If the 2018 capital rule proposal represented "fantasy rulemaking," the 2020 proposal is still predicated on the same hypothetical – the release of the GSEs from conservatorship. As noted, however, the GSEs have undergone significant reform and the FHFA appears committed to removing the GSEs within the next two years. Similarly, the 2020 capital rule proposal is a measured and appropriate take on bank capital requirements that could be applied to Fannie and Freddie out of conservatorship. Although operational challenges remain high, and the basic ability of the GSEs to retain or obtain the amount of capital required will be a significant undertaking, at a fundamental level GSE reform seems significantly more achievable. Perhaps the 2020 capital rule proposal is more appropriately considered "imaginative rulemaking."