



# *GSE Activity Report*

---

Thursday, September 3, 2020

## *Says You*

### Summary

As noted in our three summaries of key [FHFA comment letters](#), FHFA was not exactly overwhelmed by heartfelt praise for its GSE capital rule. However, stripped of the asks FHFA cannot or will not grant -- i.e., an explicit guarantee, a total rewrite treating the GSEs as insurers -- we see numerous areas in which at least some commenters will have their way. Those who don't may temper their fury by recalling that, if FHFA is forced to back down on what it and perhaps even more importantly the Fed considers key points, then systemic designation may well await Fannie and Freddie and the capital rules the Fed favors will be still more bank-like and less amenable to change.

### Impact

First to high-level issues on which we think FHFA will stand firm:

- **Delay:** Many commenters, like many Democrats, want FHFA to do nothing until FHFA is able to hear from them. Several comment letters also expressed the same concern voiced on the 2018 proposal -- how to judge a capital rule for companies that -- post conservatorship -- could be very different entities. But, without an FHFA leap into the legal unknown, only Congress can grant the GSEs the explicit guarantee sought by the bond market. With FHFA showing no sign of interest in the other capital models raised by commenters -- e.g., one akin to PMIERS or other insurance standards, a utility construct -- it will move as quickly as it can to finalize a rule it thinks fit for purpose for the GSEs now and to come. As FHFA would likely say, with a final rule, investors have certainty and the conservatorships can be transformed via contractual agreement with the Trump Treasury Department, while change hard for Democrats to undo ensues.
- **Leverage Ratio:** Although many commenters opposed the entire capital construct because it is bank-like, the leverage ratio took perhaps the greatest heat. We think objections raised by the extent to which the leverage ratio turned out to be the GSEs' binding constraint will be resolved with risk-based revisions (see below), not via a structural change to a plank of capital regulation about which the Fed feels particularly strongly. However, given the still-mysterious GSE [liquidity rule](#), recalibration could be required beyond that observable in the NPR. One way to accomplish this as a transition mechanism is to give the GSEs a temporary exemption from leverage capital on Treasury holdings and any balances at the Fed akin to the temporary supplementary leverage ratio relief [granted](#) to big banks.
- **New Forms of Capital:** Several commenters argued that g-fees and even certain CRT

tranches should be considered Tier 1 capital. When and if FHFA gets around to mandating the express TLAC standards it has threatened, it's possible that buffers along these lines might be authorized. Bank-like [TLAC](#) is problematic given the challenges facing entities with "effective" USG guarantees issuing any contingent-debt instruments benefiting from moral hazard. As clients will recall, the GSEs' brief flirtation with a subordinated-debt cushion failed when the 2008 rescue bailed sub-debt out along with all the other debt the GSEs had issued.

What might change in the final rule?

- **CRT:** FHFA took fire from all sides on its CRT provisions, concern echoed – albeit vaguely – when [Powell and Mnuchin commented on the rule before Congress](#). We expect changes to provide additional capital credit for CRT instruments backed by cash collateral, without retained first-loss tranches, with clean-up calls and – perhaps – pricing reform reducing GSE CRT subsidies.
- **Advanced Approach:** Following the bank-like construct for GSIBs, FHFA decided that Fannie and Freddie must track not only all the standardized RWAs in the proposal, but also comply with a to-be-determined advanced approach. As several commenters noted, an advanced approach from FHFA seems light years away and, in our view, allowing model reliance to substitute for one without an array of additional restrictions and floors requiring a new NPR is unwise and unlikely. We expect FHFA to acknowledge that the better part of capital valor is advanced-approach discretion, ending any suggestion of it for now.
- **Risk Floor:** The 15% RWA floor took almost universal fire on grounds – [correct we believe](#) – that this floor is far different than the bank-like requirement on which it is modelled – a 15% loss-given-default floor in the advanced approach. Lots of bank assets have a zero RWA and we expect FHFA to allow this as well to blunt criticisms that, among other problems, the rule would lead to a significant g-fee bump with adverse implications for low-income and minority borrowers.
- **Systemic Surcharge:** Many critics took issue with the systemic surcharge, a proposal in which FHFA departed considerably from the [standards demanded of GSIBs](#) to craft a market-share capital penalty. Recognizing that the GSEs are heir to substitutability, complexity, inter-connectedness, and other systemic risks, we think FHFA will go the GSIB-surcharge route.
- **Additional Changes:** With a proposal this technical, a lot can change in final form without threatening APA compliance. Among these may well be revisions to the counter-cyclical single family adjustment, removal of the cross-guarantee charge, express authorization for management-buffer and surcharge drawdowns under stress, a standardized approach to operational risk, and a lower MI haircut.

## Outlook

FHFA will hold a "listening session" on September 10 to counter criticism that it just isn't taking comments to heart, and come in for a grilling when HFSC reviews the capital proposal on September 16. But, no matter how bad this gets, a legislative repeal of the rule under freestanding law or use of the Congressional Review Act isn't likely as long as Senate Banking Chairman Crapo stands by his prior [support](#).