GSE Activity Report

Thursday, November 19, 2020

The New Mortgage Market

Summary

On Monday, we reiterated our call that FHFA would move the capital rule ASAP and then end the conservatorship as quickly as possible under terms and conditions designed to make it challenging for the Biden Administration to unravel a fait accompli. Late yesterday, FHFA issued its final capital rule on a short implementation calendar along with telling reporters that the conservatorship's end is indeed nigh. In this report, we provide our initial analysis of what post-conservatorship GSEs will look like under this new capital framework; future reports will go in depth on key strategic considerations.

Impact

It goes without saying that FHFA did not concur with Congressional opponents demanding delayed capital action, with FHFA brushing these aside yesterday with a discussion of how long the comment period proved to be and how many letters it got. Overall, the new capital rule would have cost the GSEs $283 billion in total adjusted capital as of the end of the second quarter; this would have been $263 billion under the May proposal. The difference is not so much a tougher capital rule – although it is in some key respects – but that the 9% hike in agency assets exceeds the 7% capital boost. Key as always to analytics is not gross totals, but how the capital rule's details define strategy. Initial, high-level conclusions are:

- As in the NPR, it's not just how much capital is required, but what kind of capital. The final rule continues the proposal's demand for common equity Tier 1 (CET1) capital, increasing the GSEs' need over time to rely on shareholders who, after 2008, are likely to be immune from moral hazard versus preferred-debt and other obligors who might still hope for bailout. The main difference between the Basel approach FHFA adopted and the U.S. standards is generous treatment for MSAs.
- According to FHFA, the final rule ensures that risk-based capital (RBC) is the GSEs' binding constraint under current conditions, not the leverage ratio (LR) as in the NPR. The final rule slightly reduces the extent to which the proposed stress capital buffer (SCB) is a *de facto* LR, various ceilings and floors in the RBC standard are still *de facto* LRs. However, FHFA does say that it might over time transition the overall approach to something akin to the big-bank SCB, which is premised in large part on stress testing.
- The final GSE capital requirement against total adjusted assets would now be 4.3%, but over time the capital ratio is to rise to 8%. This is below the 10% ratio at which U.S. banks are considered well capitalized but consistent with Basel's minimum. Mortgages are generally less risky than other bank loans and trading exposures, but big banks also hold about a third

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com

© 2020 Federal Financial Analytics. All Rights Reserved.

of their assets in excess reserves, Treasury obligations and other zero-weighted exposures that complicate comparison. ROE and ROA will ultimately determine the extent to which the GSEs after conservatorship retain a competitive edge in like-kind markets.

- The final rule continues to require the GSEs to maintain the higher of advanced or standardized approaches even though the GSEs have never come under advanced approaches and the final rule (as far as we can tell so far) doesn't stipulate how the advanced approach is to be computed, a sharp contrast not just to the rules for the largest U.S. banks but also from the increasing tendency of both the U.S. and Basel to rely on standardized approaches. However, in a significant concession, the advanced approaches don't kick in until 2025 at the earliest, ensuring that the GSEs needn't bother themselves with constructing a raft of new models until FHFA issues a models-based rule or a future FHFA decides whether to demand them. A near-term, SA approach to operational risk-based capital addresses Freddie's comments, but further differentiates the GSEs' rules from those governing the very largest banks.
- As anticipated, the lowest possible risk weighting for single-family mortgages is 20%, up from 15%, but still below the 50% SA for the lowest-risk loans required of banking organizations. According to FHFA's fact sheet, the average risk-weighted asset (RWA) for GSE mortgages was 43%, 37% after taking MI into account, and 31% after accounting for CRT. Overall, CRT's new treatment saved the GSEs $2.7 billion – i.e., a bit. This is still a boost to CRT over the final rule, but FHFA did not address issues such as counterparty credit quality in the final rule in order to rush it out; a subsequent rulemaking is likely.
- Significant short-term relief from the NPR comes from more generous capital weightings for loans now in forbearance and those that come out the other end. RWA breaks for certain affordable mortgages are retained, as anticipated.
- Nothing in the final rule provides the clarity commenters sought on what Fannie and Freddie will be post-conservatorship nor did FHFA agree to Freddie's request to craft different rules for each GSE based on their different business models.

Outlook

The rule is generally effective sixty days after *Register* publication, giving FHFA good odds that this occurs well before a Biden Administration has time to consider the extent to which it could override the agency or Congress – should Democrats gain the Senate in January – are able to agree on a Congressional Review Act revocation. The final rule's compliance date is the later of the effective date, the end of the conservatorships, or any later date allowed in a consent decree or other transition order. Even so, the buffers would go into effect at the later of the end of the conservatorships or effective date without consideration of a transition period so that FHFA can order capital-distribution and discretionary-bonus restrictions even if Fannie or Freddie is otherwise out of the conservatorship's clutches. Any such interim period will be governed by a capital-restoration plan, plans apparently to be set under a rule FHFA has yet to promulgate. Should it decide to act more quickly, the agency could use its longstanding PCA powers to clip the GSEs' capital wings.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com

© 2020 Federal Financial Analytics. All Rights Reserved.