Friday, December 17, 2021

Building Buffers

Summary

As noted on Thursday, FHFA continues to tread carefully through the big-bank rulebook, adopting standards said to be like-kind that aren't quite so similar when it comes to critical details. The latest proposal demands capital planning in a construct akin to the one Democrats favored as the agencies finalized the big-bank stress capital buffer (SCB) minus express restrictions on capital distributions. Although the SCB will make Fannie and Freddie more resilient, it also steepens the climb out of conservatorship unless some new capital comes along.

Impact

Consistent with the Fed's overall capital-planning framework, FHFA here stresses that it is setting minimum standards and that each GSE's board is responsible for ensuring these even after taking the new SCB into account. Much in the NPR tracks the details of the big-bank framework, but differences are intriguing. Most significant of these is the difference in the buffer; for big banks, it's 2.5%; for the GSEs, it would be 0.75%. FHFA has also not gone as far as the Fed with regard to limiting its right to object to capital-plan and stress-test results, a change siding with Democrats as they considered both the SCB and related stress-test requirements.

The big-bank SCB is largely risk-based while the FHFA proposal stress tests overall capitalization, thus covering both risk-based and leverage ratios. Deletion of the enhanced supplementary leverage ratio from the final SCB was strongly opposed by Brainard at the Fed. Like the banking agencies, FHFA wants risk-based capital to be the binding ratio; unlike them, it nonetheless proposes to stress leverage to ensure if also suffices under stress. As a result, it seems clear that FHFA will not take action (e.g., fiddling with a denominator) if the leverage ratio dominates in the wake of CRT or other risk-mitigation tactics.

The FHFA's SCB is also mission-oriented. This is in sharp contrast to another controversial provision in the final banking SCB, which deleted ongoing lending-capacity assumptions from the stress scenarios. The FHFA proposal also doesn't give the GSEs the latitude big banks controversially got in the final rule to plan on the basis of an ability to suspend planned capital distributions. But, while the GSEs would thus have to assume that they will stay all capital distributions even under acute stress, they actually aren't making any capital distributions, making this moot for the foreseeable future.

While these changes are unsurprising – i.e., that capital plans must ensure mission compliance – others hint at a new future. For example, the preamble to the proposal notes that the framework covers not just capital distributions – the focus of the Fed's standards – but also capital raises. There's nothing technically novel about this, but it stands as an important reminder that Fannie and/or Freddie could raise capital even in conservatorship if market conditions or even a couple of big investors are promising. Conversely, the rule would require that internal scenarios cover five years – not the nine

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quarters in the bank rules – on grounds that this is necessary to assess overall capital-rebuild plans.

Outlook

Consistent with our initial assessment, our in-depth view reinforces FHFA's conclusion that its SCB will have little practical impact anytime soon. Still, it matters – a lot – if one harbors hope for an end to conservatorship anytime soon. Comments on it are due sixty days after *Register* publication.

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