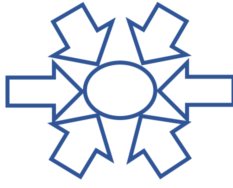

GSE Activity Report

Monday, February 27, 2023

A Consequential Capital Clean-Up

Summary

FHFA has proposed a set of refinements to the current GSE capital construct. As proposed, none makes a major difference in how much risk-based or leverage capital Fannie and Freddie must hold, but several of the revisions have strategic implications now and even more to come if the GSEs push hard and FHFA presses on to expand their footprint in several key arenas.

Impact

As noted in our preliminary assessment of this proposal, one interesting change would defer implementation of the current rule's advanced approach until 2028. As we have noted over the years, the banking agencies have thought about simply dropping the advanced approach and have sharply scaled back its use for all but the biggest banks. We expect the end-game rules to eliminate the advanced approach in its entirety, although views among the biggest banks about the advisability of doing so continue to vary.

The most significant changes to risk weightings would:

- Drop the RWA for UMBS exposures to 5% from 20% and lower the CCF to 50% from 100%. The proposal would also subtract guaranteed obligations from GSE assets. This should reduce the CET1 capital cost of these commitments by $5.1 billion and lower the odds that Fannie will issue "supers," i.e., re-securitizations of UMBS. Comment is sought on whether GSEs could indemnify each other or otherwise provide protections that further reduce the capital cost of UMBS;

- Ease the capital treatment of multifamily guarantees when projects are backed by certain government subsidies, with FHFA arguing that the various controls stipulated in government projects provides more credit protection than private loans. We have our doubts given the often-problematic nature of these projects, but the proposal does enhance FHFA's equitable-finance objectives along with providing $0.4 billion of capital relief. This capital benefit could get bigger if FHFA is persuaded by answers to questions about whether subsidies eligible for reduced risk-based capital should be liberalized;

- Long-planned updates to the capital treatment of positive derivatives exposures to match the approach adopted in the mid-2010s for like-kind bank exposures (SA-CCR) which takes netting and certain other key risk mitigants into account;

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- Add the credit valuation adjustment (CVA) to standardized total risk-weighted assets, again an overdue alignment of FHFA's standards with global and U.S. bank rules. Unlike the U.S. approach, the CVA would apply only to the GSEs' standardized approach, but as noted, FHFA is also delaying application of the advanced approach surely in a wait-and-see if the U.S. does the same in the end-game rewrite later this year. Both the CVA and SA-CCR changes add only $100 million to total GSE capital requirements;

- Fiddle with how credit scores are computed to reflect recent FHFA changes in how Fannie and Freddie are to use credit reports. The revisions also reflect growing use of non-traditional scores by liberalizing the RWA calculation for "unscored" mortgages. Each of these changes has negligible impact on minimum capital;

- Add a new RWA for GSE guarantees (i.e., those for as-yet-unsecuritized single-family loans). This would be set at 20% versus the current, default 100% RWA. The 20% RWA would also apply to any mortgages held in portfolio. This would drop current capital by $200 million, but this change could have significantly more impact if FHFA allows the GSEs to back covered bonds or engage in other forms of credit enhancement;

- Make a relatively technical change to the definition of MSAs with no immediate capital consequence;

- Slightly liberalize CRT capital for instruments with clean-up calls with time-based features. These are frequently used in current CRT structures but now barred from capital benefit due to the current rule's operational standards if the call meets new eligibility standards;

- Refine the counter-cyclical buffer during rapid house-price appreciation scenarios to facilitate reinsurance CRT by speeding up a key buffer calculation; And

- Make numerous other, even smaller changes with still less strategic consequence.

Outlook

Only the UMBS and subsidized-housing changes makes a major capital difference to the GSEs and, even then, each would remain severely under-capitalized compared to regulatory-capital minimums. However, as evident from the boomerang effect of CRT-related capital changes, these rules have significant strategic impact as Fannie and Freddie strive to climb out of the limbo to which they have now been confined for over fifteen years. The most interesting of the changes from a strategic perspective is the aforementioned drop in the RWA accorded portfolio and guaranteed non-MBS obligations. If FHFA is willing, Fannie and Freddie have considerable scope to expand into an array of new-product arenas with this capital wind at their back.

FHFA has in general kept the questions on which it seeks comment narrowly confined to each specific proposal. It will surely get lots of comments with lots of other ideas, especially when it comes to CRT and guaranteed obligations. How far FHFA is willing to push the final rule in light of these off-topic comments remains to be seen, but many agencies have been known to press hard and fast on issues barely noted, if at all, in an initial proposal.

Comment on the NPR is due sixty days after Federal Register publication, with FHFA eyeing an effective date of sixty days after finalization. Given the relatively simple nature of these changes and all this advance warning, that sounds more than doable even as possible strategic repositioning begins.

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