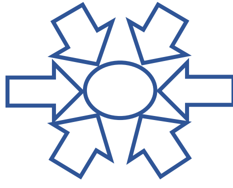

GSE Activity Report

Monday, November 27, 2023

An Advanced View of Regulatory Capital?

Summary

The most significant thing in FHFA's final capital rule is not what is to be done, but what FHFA left out: ending the GSEs' advanced-approach requirement. As a result, Fannie and Freddie can still use models for key calculations, a requirement that makes more sense for two complex organizations than it did for the regional banks also long subject to advanced-approach requirements even though the rules required them, like GSIBs, to hold the higher of the standardized or advanced approach.

Impact

As we noted in our assessment of the proposal, FHFA knew well that the banking agencies planned to abandon the advanced approach, with FHFA signaling interest in doing so even as it proposed only to extend the compliance timeline until 2028. The final rule retains the extended deadline, observing only that the banking agencies have in fact proposed to abandon the advanced approach for all large banks in concert with proposing new standardized credit, market-, and operational-risk weightings. Oddly, the banking agencies have retained the "dual-stack" construct even without the advanced approach, requiring banks to hold the higher of the old or new standardized capital requirements even though, as Karen Petrou noted in Congressional testimony, there's no rationale in the rule for why the higher-of approach is needed if the agencies think the new standardized weightings are better.

The GSEs' ongoing advanced-approach requirement will force Fannie and Freddie to ready all the complex systems needed to run the internal-ratings based approach. Should FHFA stick to its standards in 2028, the capital gulf will widen between banks and the GSEs in strategic ways sure to be seen once the big-bank framework is finalized.

Otherwise, the final rule anticipates aspects of the new standardized weightings for banks without taking account of the higher-of construct and cleans up a few outstanding items. Key changes will:

- Drop the RWA for UMBS exposures to 5% from 20% and lower the CCF to 50% from 100%. FHFA refused to set RWAs at zero on grounds that UMBS have risk even though each GSE already holds capital against the obligations backing its part of the UMBS because GSEs lack a full-faith-and-credit USG guarantee;
- Introduce a risk multiplier under the standardized approach equal to 0.6 to 1.0 for any multifamily mortgage exposures secured by one or more properties with at least one applicable government subsidy (i.e., LIHC, Section 8, certain rural programs, and state/local affordable-housing programs). Additional affordability requirements also apply. Scaling depends on how many units are backed by government subsidy, although all eligible properties must have units backed by eligible subsidy of at least 20% of total at acquisition;

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- Implement 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. The new rule also imposes a credit valuation adjustment (CVA) akin to one in current big-bank rules. However, internal-model reliance is reduced, with FHFA here echoing the banking agencies' distrust of models in the pending capital rewrite even though other aspects of the SA-CCR and CVA are being significantly redesigned and toughened. The GSEs have a 24-month transition period before adopting this new approach. The final rule leaves unsaid the extent to which FHFA plans yet another rewrite if its final rule materially differs from the final banking standards;
- Fiddles 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. However, FHFA dropped the proposed requirement for setting capital based on a representative score until any subsequent decision following implementation of the bi-merged scoring methodology;
- Sets an RWA of 20 percent for guaranteed assets as proposed, without the proposal's inclusion of guaranteed assets in the definition of covered positions subject to market risk capital requirements; and
- Finalizes various minor changes liberalizing capital treatment for MSAs under certain circumstances, CRT clean-up calls, IO MBS, the counter-cyclical adjustment for single-family mortgages, and stability buffer.

Outlook

All but the SA-CCR changes will be effective on April 1, 2024. Nothing in the rewrite materially changes the pace at which Fannie and Freddie are likely to become adequately capitalized and thus free themselves of the conservatorship's shackles.

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