



FACT SHEET: PROPOSED RULE TO AMEND ENTERPRISE REGULATORY CAPITAL FRAMEWORK

FHFA PROPOSED RULE TO AMEND ENTERPRISE REGULATORY CAPITAL FRAMEWORK

BACKGROUND

The Housing and Economic Recovery Act of 2008 amended the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 to require the Federal Housing Finance Agency (FHFA) to establish, by regulation, risk-based capital requirements for Fannie Mae and Freddie Mac (the Enterprises) to ensure that each Enterprise operates in a safe and sound manner, maintaining sufficient capital and reserves to support the risks that arise in the operations and management of the Enterprises.

On December 17, 2020, FHFA published a final rule to establish the Enterprise Regulatory Capital Framework (ERCF), which was a re-proposal of the regulatory capital framework proposed in 2018.

FHFA is seeking comments on a notice of proposed rulemaking (NPR or proposed rule) that would amend the ERCF by refining the leverage buffer and the risk-based capital treatment of credit risk transfer (CRT) transactions. These amendments are intended to facilitate an environment where leverage is not the binding capital constraint for the Enterprises and where the Enterprises have incentives to distribute acquired credit risk to private investors through CRT rather than to buy and hold that risk.

SUMMARY OF THE PROPOSED RULE

Changes to the Prescribed Leverage Buffer Amount

The ERCF requires an Enterprise to maintain a leverage ratio of tier 1 capital to adjusted total assets of at least 2.5 percent. In addition, to avoid limits on capital distributions and discretionary bonus payments, an Enterprise must also maintain a tier 1 capital PLBA equal to at least 1.5 percent of adjusted total assets.

FHFA is proposing a recalibration of the PLBA because a consistently binding leverage ratio could lead to perverse outcomes at the Enterprises, including promoting risk-taking and creating disincentives for CRT and other forms of risk transfer. The proposed rule would replace the fixed 1.5 percent PLBA with a dynamic leverage buffer determined annually and equal to 50 percent of an Enterprise's stability capital buffer.

SUMMARY

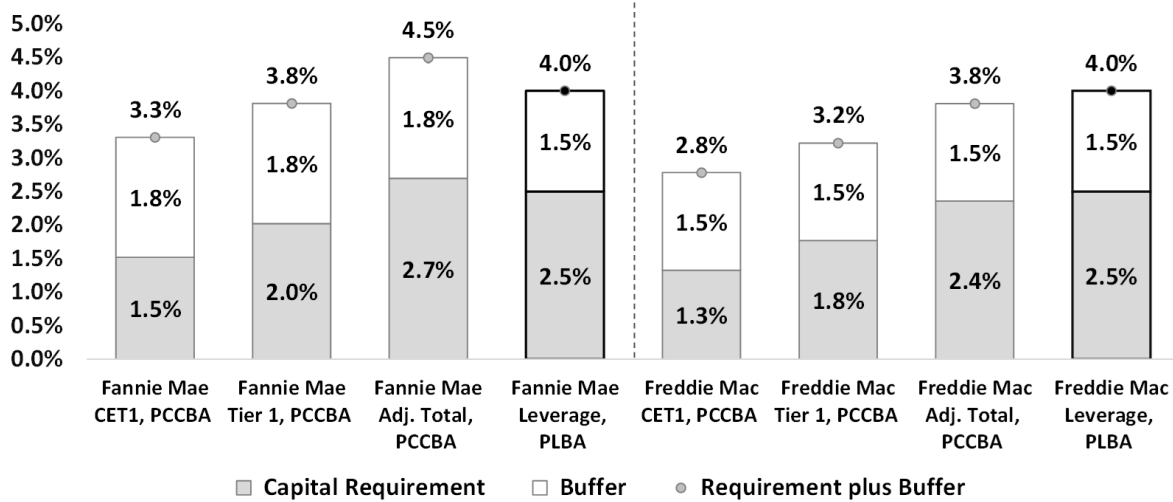
The proposed rule includes three areas of refinement to the current capital rule:

- Replace the fixed prescribed leverage buffer amount (PLBA) equal to 1.5 percent of an Enterprise's adjusted total assets with a dynamic PLBA equal to 50 percent of the Enterprise's stability capital buffer
- Replace the prudential floor of 10 percent on the risk weight assigned to any retained CRT exposure with a prudential floor of 5 percent on the risk weight assigned to any retained CRT exposure
- Remove the requirement that an Enterprise must apply an overall effectiveness adjustment to its retained CRT exposures

The NPR also poses specific questions for public comment on these changes and proposes several technical corrections to the final rule published on December 17, 2020.



Estimated Enterprise Capital Requirements and Buffers relative to Adjusted Total Assets, as of March 31, 2021



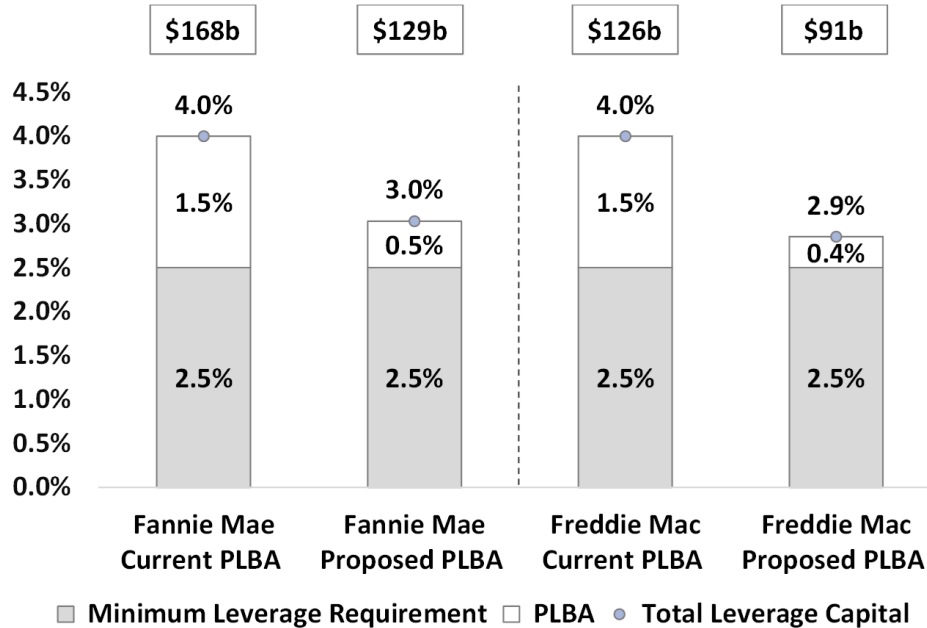
The proposed rule would support the primary purpose of the leverage requirement and buffer to serve as a credible backstop to the risk-based capital requirements and risk-based capital buffers. Such an environment would provide the Enterprises with incentives to manage their capital and shed risk using CRT. In addition, the proposed rule would more closely align the ERCF with an approach implemented internationally in the Basel Accords with respect to leverage requirements for global systemically important banks.

Under the amended rule, as of March 31, 2021, Fannie Mae’s PLBA would decrease from approximately \$62 billion, or 1.5 percent of adjusted total assets, to approximately \$23 billion, or 0.53 percent of adjusted total assets. Freddie Mac’s PLBA would decrease from approximately \$46 billion, or 1.5 percent of adjusted total assets, to approximately \$11 billion, or 0.35 percent of adjusted total assets. With the new dynamic leverage buffer, FHFA expects that the risk-based capital requirements will be the binding capital constraint for the Enterprises.





Estimated Enterprise Leverage Capital under the Current ERCF and the Proposed Rule, as of March 31, 2021



Changes to Credit Risk Transfer Risk-based Capital Requirements

FHFA views the transfer of unexpected credit risk to a broad set of global investors as an important tool to reduce taxpayer exposure to the risks posed by the Enterprises and to mitigate systemic risk to the housing finance market caused by the size and monoline nature of the Enterprises’ businesses. FHFA believes that CRT is an effective mechanism for such a distribution of unexpected credit risk especially while the Enterprises are in conservatorships and have inadequate capital positions relative to their overall books of business. FHFA has over the past eight years instructed the Enterprises through guidelines, directives, strategic plans, and scorecard objectives to develop and enhance their CRT programs, which have now become an integral part of the Enterprises’ business models since they were first implemented in 2013.

There are many benefits to CRT, including reduced risk to taxpayers from a severe housing crisis, diversification of risk, and potentially lower cost of capital. CRT transactions transfer a meaningful amount of credit risk to private investors in severely stressful economic scenarios, which helps to protect taxpayers from potentially large credit-related losses. CRTs also distribute credit risk broadly across the global financial system to reduce the systemic risk posed by the Enterprises. To accomplish this, the Enterprises use different transaction structures to attract a diversified and broad set of investors to improve pricing, increase secondary market liquidity, and promote market stability. These transactions include fully-funded securities issuances and partially collateralized pool-level reinsurance contracts where the Enterprises have significant control over the claims process.





Further, CRT can be a cost-effective, economically sensible option to absorb credit losses in a severe housing downturn when compared to equity capital. An economically sensible CRT is not one that is low-cost on an absolute basis, but rather one where the cost to the Enterprise for transferring the credit risk does not exceed the cost to the Enterprise of self-insuring the credit risk being transferred using equity capital. CRTs are insurance against a severe stress to the housing sector and protect the Enterprises against high-cost, low-probability events, even when those events do not occur. Therefore, the lack of significant defaults does not imply that CRTs are ineffective or economically unreasonable. CRT premiums should be weighed against the relief from capital requirements, imputed capital constraints, imputed or actual costs of capital and other factors. Since 2013, FHFA has encouraged the Enterprises to engage in economically sensible transactions and to account for both the costs and benefits of CRT transactions. Market conditions, in addition to a transaction's cost and structure, ultimately determine a CRT's relative profitability. If CRT premium payments are low relative to the cost of additional equity capital an Enterprise would need in the absence of the CRT, then the Enterprise has the opportunity to execute economically sensible CRT transactions that provide credit risk protection at a lower cost than equity capital.

In addition to being economically sensible, the CRT market has recently been shown to be relatively resilient to economic shocks, assuaging some concern as to the market's long-term viability. Following the immediate onset of the COVID-19 pandemic in the United States, financial markets, including CRT markets, experienced a liquidity shock and spreads widened significantly. In response, the Enterprises halted their CRT issuances. However, as housing markets rebounded in the second half of 2020 from the economic stress caused by COVID-19, Freddie Mac resumed securities and reinsurance CRT issuance at an accelerated pace, providing evidence that CRT represents an effective tool for distributing credit risk through the economic cycle. Due in part to the observed resiliency of the CRT market, FHFA continues to believe that CRT could facilitate regulatory capital planning in furtherance of the safety and soundness of the Enterprises and their countercyclical mission, and that the Enterprises' CRT programs can help facilitate the continued acquisition of higher risk loans throughout the economic cycle due to capital relief afforded to risk transfer.

To further encourage the Enterprises to engage in CRT, the proposed rule would amend the CRT securitization framework by replacing the 10 percent risk weight floor assigned to any retained CRT exposure with a 5 percent risk weight floor. This would address concerns that the current risk weight unduly decreases the capital relief provided by CRT and reduces the Enterprises' incentives to engage in CRT.

The proposed rule would also remove the largely duplicative requirement that an Enterprise must apply an overall effectiveness adjustment to its retained CRT exposures. FHFA has determined that it is an appropriate place to make a refinement within the CRT securitization framework to further promote the use of CRT without increasing safety and soundness risks at the Enterprises.

With these refinements, FHFA seeks to ensure that the rule does not create undue disincentives to CRT, promotes consistency with the U.S. banking framework, and mitigates the safety and soundness, mission, and housing stability risk that might be posed by some CRT.

To provide additional transparency to the public, FHFA published an updated CRT spreadsheet tool (tool) comparing the current capital rule and the proposed CRT enhancements. The tool shows how CRT formulas work and allows users to input assumptions and calculate the amount of capital the Enterprises are required to hold across retained risk exposures in different types of CRT transactions. The tool will better inform public comment on the proposed treatment of CRT. The tool can be found on FHFA's website.¹

¹ <http://www.fhfa.gov/Media/PublicAffairs/Documents/Enterprise-Capital-CRT-Tool-2021.xlsx>.

