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August 28, 2020

Enterprise Regulatory Capital Framework

Federal Housing Finance Agency

Proposed: May 20, 2020

Comment Period Closes: August 31, 2020

Submitted: August 28, 2020

Docket No. 2020-11279

RIN: 2590-AA95

Re.: Enterprise Regulatory Capital Framework

Dear Sir/Madam:

Thank you for the opportunity to comment on FHFA's proposed rulemaking on the Enterprise Regulatory Capital Framework. We recommend that FHFA make major changes to its proposed Enterprise Capital Requirements before final approval.

It would be a pleasure to discuss this recommendation further with you at your convenience, should you so desire. Thank you again for the chance to participate in this timely rulemaking.

Yours respectfully,

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# Enterprise Regulatory Capital Framework

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*August 28, 2020*

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FHFA's 2020 proposed capital rule for Fannie Mae and Freddie Mac is a major improvement over the 2018 version. By mandating significantly higher levels of capital and introducing a critical countercyclical dimension to the requirements, the new proposal would greatly reduce the potential for these government-sponsored enterprises (GSEs) to fail again, as they both did twelve years ago. In both of those respects, the rule can be -- and needs to be -- strengthened. But this clearly is a good start.

## **The GSEs Need Serious Capital Standards, not Band-Aids**

Both the FHFA's expressed intent to recapitalize the GSEs and release them from conservatorship and the recent coronavirus-induced economic recession highlight the importance of getting this rule right. The former consideration implies that this is far more than an internal management pricing tool, and it reminds us of the special supervisory difficulties that GSE status entails. Compared with other large financial institutions, GSEs have much weaker market discipline, have powerful incentives to expand the range and risk of their activities, and can develop exceptional political influence. The latter brings home the realization that the 2008 housing debacle is not necessarily a once in a lifetime event. While housing markets have performed well under the circumstances this year, the economic outlook is very uncertain, with 4.9 percent of GSE loans in forbearance (week ending August 16) and serious housing finance losses possible or even likely if the economy does not recover as thoroughly or swiftly as hoped.

As we noted in our comments on the 2018 proposal, the GSEs need to have ample capital not only to protect taxpayers and creditors from potential loss, but also (perhaps even more importantly) to enable them to continue to conduct new business at critical times. The U.S. housing finance system is dominated by these two institutions, and we lack other institutional capacity to suddenly replace them. During conservatorship we have increased institutional risk by making them more and more like each

other, even to the point where investors treat the fixed-income securities they issue as interchangeable. If one goes, the other is almost sure to go as well.<sup>1</sup>

Sizing the amounts of required capital is admittedly not easy. If those amounts are very high, considerably higher than those required of potential competitors, the GSEs will not be able to compete profitably for new business. The GSEs' 2008 experience, on the other hand, illustrated the consequence of too lenient requirements. Until circumstances got particularly dire, investors ignored the absence of meaningful GSE capital and relied on what they viewed as an implicit federal guarantee. Eventually, the deep mark-to-market insolvency of the GSEs led investors to demand increasingly larger yields on GSE securities, relative to risk-free yields. After over a decade of GSE and housing lobby induced delay and just four months before the GSEs were placed in conservatorship, Congress passed legislation that made continuing operations under conservatorship practical by providing a source of emergency funding. Even after implementing conservatorship and the Treasury's new spending authority, investors remained vigilant. As losses mounted, the Treasury needed to first double the amount it had agreed to make available to cover losses, then to add contingent amounts that could be added past the expiration date of the authority. Finally, to meet investor concerns that those amounts might be inadequate, Treasury and FHFA changed the computation methodology for the dividends Treasury received on its investment to further lower the chance that the funds would run out.

In effect, the Treasury's actual and remaining potential funding served as the GSEs' capital, as it still does today. It is not clear to what extent the markets will view recapitalized GSEs as benefitting from an implicit guarantee. Those that bet in 2008 that the guarantee was real were rewarded, but legislation enabling funding for it was provided just in advance of need. The experience just two months later with legislation for the Troubled Asset Relief Program (TARP), both its difficulty in getting enacted and its continuing widespread unpopularity, should caution any assumptions about a future Congress' willingness to provide that an implicit guarantee of this sort is sure to be honored. Prudence dictates we assume the worst: that if GSE capital is inadequate investors will provide no helpful market discipline until and unless it is too late to help, at which point, given the housing market's great reliance on the GSEs, it may totally collapse without emergency support.<sup>2</sup>

Another important and related lesson from 2008 and the years following is that capital in the amount of the institution's ultimate losses is woefully insufficient. Fannie Mae suffered lifetime losses of \$85 billion on its 2007 book of single-family loans, but at the end of 2011, it had taken \$155 billion of credit losses before it was later able to reverse some of its write-downs. Furthermore, at about the same time, FHFA was projecting that Fannie Mae losses still could be as much as an additional \$103 billion.

### **Deficiencies in the 2018 Proposal and FHFA's 2020 Changes to Address Them**

FHFA's 2018 proposal based the credit risk component of its risk-based requirement on only the final losses on its loans. Small amounts were added for interest rate and operational risk and a catchall 75

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<sup>1</sup> From time to time, some commentators have proposed merging the two GSEs into one utility-type entity. This approach would further compound the challenges of ensuring capital adequacy. It would concentrate risks more emphatically, magnifying the consequences of a single operational failure, and at the same time maximizing the political clout of a single institution, helping it to dominate its regulator and avoid sufficient supervision. Also, by eliminating inter-GSE competition, it would reduce the GSE's risk of adverse selection by loan sellers, leading to sloppier underwriting and less careful risk-based pricing.

<sup>2</sup> This is an argument for dramatically reducing the GSEs' footprint.

basis points (about \$24 billion for Fannie Mae) to ensure the GSEs could be seen by investors as “going concerns.” Altogether, the risk-based requirement averaged about 3.24 percent of assets when applied to the GSEs 2017 books of business, or an effective 2.76 percent after adjusting capital by subtracting deferred tax assets (DTAs).

In our comments on that proposal, we urged FHFA to increase the requirement by 200 basis points (2.00 percentage points) to ensure the GSEs could continue to function throughout a housing downturn comparable to the 2008-11 experience and to make the GSEs’ requirements more consistent with those of large banks. In doing so, we took account of GSEs’ improved underwriting standards, but we also recommended additions to cover model risk, including the risk that standards may well deteriorate in ways that the loan or borrower characteristics contemplated by the rule do not take into consideration. We also incorporated a boost to the extremely small operational risk component, and we recommended tightening the measure of capital by removing loan loss reserves and limiting use of preferred stock. Finally, we urged FHFA to adopt capital requirements that rise significantly in housing booms to recognize the heightened risk during booms, dampen lenders’ enthusiasm for new lending in such periods, and reduce the need to raise additional capital in the most difficult environments. The 2018 proposed rule would have done just the opposite.

With respect to FHFA’s 2018 proposed leverage requirement (2.5 percent of assets or an even lower alternative), we pointed out that it would have been even less useful in 2008 than the proposed risk-based standard. It would have covered barely half the losses during 2008-11. In this proposal, DTAs were neither added to the requirement nor deducted from capital. After absorbing valuation adjustments applied to DTAs, remaining capital would have covered only 0.64 percent of assets in the better of the two alternatives.

The 2020 proposal partly or fully addresses most of our concerns with the earlier proposal. Most importantly, both the risk-based and leverage standards have been stiffened by adding sizable bank-like capital buffers, and by using bank-like definitions of capital that, for the most part, raise the quality of capital. The overall structure of the rule has been reshaped to look much more like the rules for large banks, which adds complications. To be fully compliant under the 2018 proposal, the GSEs needed to meet two capital standards, leverage and risk-based, using two definitions of capital, “core” and “total,” which are defined by statute. The new proposal adds new requirements based on three capital measures modeled after those used in bank regulation. The new requirements effectively displace the statute-mandated requirements because the bank-like definitions are tighter.

The new leverage standard is defined in terms of tier 1 instead of core capital. The primary difference is that tier 1 subtracts most DTAs. It also subtracts goodwill and other intangibles, but these historically have not been important for the GSEs. The new risk-based standard uses adjusted total capital instead of the statutory total capital. The adjustments eliminate most DTAs and reserves for expected losses. Furthermore, at least three-fourths of the risk-based standard must be met with tier 1 capital, and three-fourths of eligible tier 1 capital must qualify as Common Equity Tier 1 (CET1), which does not include preferred stock. These are all important improvements.

Unfortunately, though, adjusted total capital also includes what banks call “tier 2,” which adds a host of quasi-capital instruments of questionable merit. Particularly unfortunate is the inclusion of subordinated debt, which history shows to be of no value in absorbing losses for GSEs. In 1992, the legislation establishing the current capital definitions did not include it because investors in GSE

subordinate debt had not demanded yields materially above senior debt, as they viewed the subordinate debt as falling under the implicit guarantee. In 2000, under pressure from members of Congress and the Treasury, the GSEs announced “voluntary” initiatives to issue subordinated debt, which they did at modest yield premiums. However, when they failed in 2008, the FHFA-Treasury agreements to fund the conservatorships effectively guaranteed the subordinated debt, both principal and interest, so none of it was available to absorb losses. The lesson should be clear: whatever its merit as a contributor to bank capital, subordinated debt has no place in measures of GSE capital.

The 2020 additions to both the risk-based and leverage standards are almost entirely in the form of bank-like capital buffers. If a GSE does not have the full prescribed amount though, the penalty is limited to restrictions on the sum of dividends, share repurchases, and bonuses. Those restrictions are not onerous unless the deficiency is large. In view of the new proposal’s heavy reliance on these buffers, it is important that FHFA must be willing and able to use other tools to enforce its statement on page 102 of its proposal that “it would not be consistent with the safe and sound operation of [a GSE] for the [GSE] to maintain regulatory capital less than its buffer-adjusted requirements in the ordinary course except for some reasonable period after a financial stress.”

#### The Risk-Based Standard

The actual risk-based requirements (excluding buffers) remain low. FHFA has tightened them somewhat by establishing minimum risk-weights for all loan exposures, by more carefully recognizing limitations of credit risk transfer benefits, and by raising the operational risk component from 8 to 15 basis points. Those increases to the requirements were offset by removing the assessment of 75 basis points in the 2018 version that was intended to provide capital to enable the GSEs to remain “going concerns” after large losses. Those amounts became part of the buffer.

Furthermore, the impact of the 2018 proposal has weakened over the past two years, largely because of the rapidly rising house prices since it was developed. Based on the 2017-q3 GSE books, the risk-based requirement (adjusted for DTAs) was 2.76 percent of assets on average for the two GSEs. The same rule would have required only 2.13 percent capital for 2019-q3 because of changes in the GSEs’ balance sheets over the two-year period. The principal differences were an increased use of credit risk transfers and the procyclical effect of rapid increases in house prices. Those increases are important because of the way loan-to-value ratios (LTVs), a key risk characteristic, are calculated. For purposes of the rule, LTVs are marked-to-market, so that after a period of large price increases, the LTVs of loans remaining on the balance sheet during that period are significantly reduced. We discuss this further in the “countercyclical” comments below. FHFA proposes a change to its treatment of LTVs in certain market environments, but the period over the past two years would not be affected. Thus, even though the new version is not weaker, on balance, than the earlier version, when applied to the 2019-q3 book it requires only 2.22 percent capital (on average for the two GSEs), a reduction of more than half of a percentage point from what we commented on last time. The buffers add 1.63 percentage points for a total of 3.85 percent.

Counting those buffers, that is an increase of 109 basis points, or about half of the 200 basis points we recommended and still recommend. About half the remaining difference, 50 basis points should be added to the requirement, not the buffer, to account for model risk. That encompasses not only the stochastic variations in actual outcomes associated with applying any new data set to the models the rule is based on, but also the almost inevitable relaxation of underwriting standards over time in ways

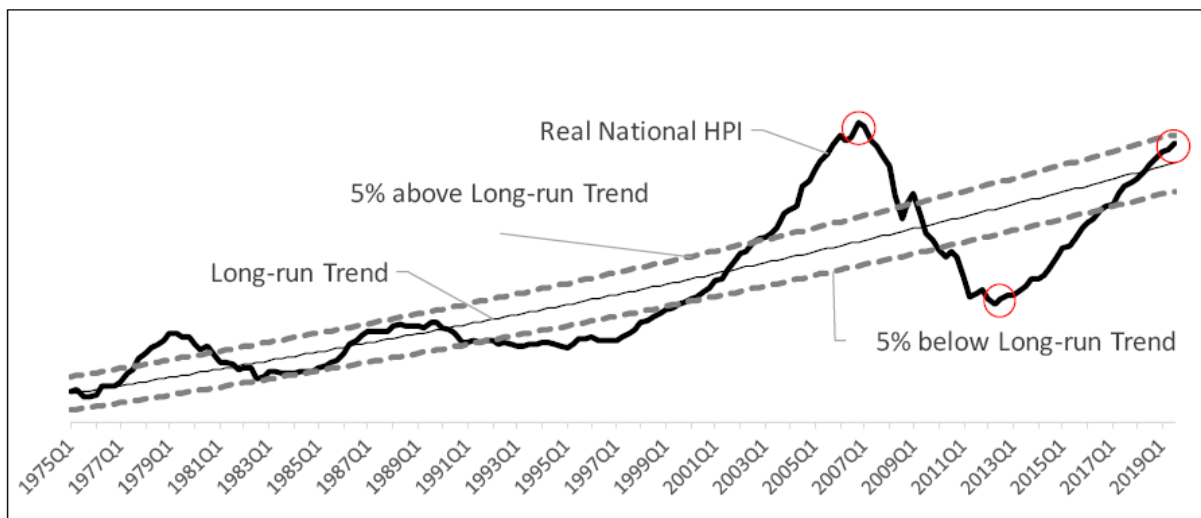
not reflected in the variables used in the rule, as well as the increasingly difficult legal environment with respect to foreclosures and evictions. Because of their GSE status, Fannie Mae and Freddie Mac are almost sure to benefit from funding costs that do not fully reflect the risks they have, so taking risk is cheaper for them than for fully private institutions. We would also add another 10 basis points to operational risk to reach the 25 basis points we recommended last time. As FHFA notes in the preamble, large banks average 69 basis points. While GSE operations are simpler, just considering the mammoth accounting restatements each made just a few years before the crash, as well as the large reputational risks each carries with GSE status, argue for a higher number. The remainder can easily be incorporated in improvements to the countercyclical element in FHFA’s proposal.

### The Countercyclical Element

One of most valuable changes in the new proposal is its addition of a countercyclical element that in unusually booming or cratering housing markets transforms a capital regime from one that would perversely lower the amount of capital required when risks rise and raise it when risks fall into a regime that is countercyclical by doing the reverse. In the 2018 proposal, loan risk is evaluated based on mark-to-market loan-to-value ratios (MTM LTVs), so that a loan with an outstanding balance of, say, 84 percent of the collateral’s estimated current market value requires the same amount of capital regardless of whether house prices generally are at, well above, or well below their long-run trend levels.

Evaluating loan risks based on current market values would make sense if house prices followed a random walk over time, but house prices exhibit significant cyclicity, as shown by figure 1 from page 121 of the proposal.

**Figure 1: Real National HPI 1975 Q1 to 2019 Q3, Long-term Trend (1975 – 2012), and Collar**



Source: FHFA

As prices move up into more boom-like conditions, both the risk of price declines and the potential size of those price declines increase. A rise in house prices lowers MTM LTVs of loans in a GSE's portfolio, which lowers the capital required for those loans, but risk of loss in a deeply stressful event remains about the same. Over the course of a house price cycle under the 2018 proposal, a GSE's capital requirements would fall to very low levels at price peaks, possibly triggering large common stock share repurchases, when risk is greatest. Requirements would rise when prices fall, creating needs for increasing amounts of new capital just when it becomes more and more difficult to raise it. Moreover, as prices rise, the risks on new loans are greater than those of earlier loans when they were new, because they are further along in the cycle. However, under the proposed rule, the capital need on the new riskier loans is the same as it was for the earlier less risky loans. As result, the GSE has no capital-related incentive to raise its fees.

The risk weights of the various loan buckets in the rule are based on coefficients in estimated default risk equations. Those equations rely on MTM LTVs because they are strongly related to the likelihood of default in the short run. Over the life of a loan, though, the risk of a loan also depends on the relative likelihood of different future price paths, and those likelihoods change over the course of a cycle. Capital requirements for banks are based on the original LTVs of loans, so that cyclical house price changes have relatively little effect on those requirements. That is a better approach, but much better still would be to add a countercyclical element, raising capital when risks are increasing, and letting it fall when prices are already low and further major declines are less likely.

FHFA has proposed whenever real house prices deviate from trend by more than 5 percent, the 2020 rule would adjust each loan's MTM LTV to what it would be if house prices moved immediately to reduce the deviation back to 5 percent. In a boom, once past the trend plus 5 percent collar, further price increases above trend will not reduce the capital charges for loans in portfolio at that time, and new loans originated when prices are at elevated levels will get bigger capital charges than comparable loans originated with the same LTVs during lower price periods initially received. For example, an 80 percent LTV loan originated when prices are 10 percent above trend initially will be treated as though it was an 83.8 percent loan.

Were such a feature in force the during a period like the years 2004 to 2006, the GSEs would have needed a series of capital infusions well before prices peaked and they would have had an incentive to raise fees sufficiently to cool demand and slow unsustainable price increases. In years like the early 2010s, when house prices were depressed, the reverse would have been true.

This is a path breaking innovation in the field of financial institution regulation. Nonetheless, the rule can and should be strengthened by reconsideration of some of the details of the proposed implementation. The need for such strengthening is apparent in Figure 1. It shows a strong price boom beginning in 2012 and continuing through 2020-q1. Yet, the upper 5 percent collar had not been breached. As a result, FHFA's suggested approach would fail to prevent further capital reductions due to continuing marked-to-market value adjustments to the existing portfolio. More recent data indicate the current boom is not only continuing, but accelerating. At the same time, the economy is facing high levels of stress and large numbers of potential defaults due to the coronavirus pandemic. A strong capital rule should force rising capital ratios leading up to such circumstances, not declining ratios.

This might be corrected with three simple adjustments that we strongly support. First, the same reasoning that supports a countercyclical adjustment at some predetermined threshold during boom

and bust periods, also supports it as the boom is building or the bust is deepening. Unfortunately, FHFA's proposal would allow capital to be siphoned off even in early 2020, because when real house prices are still within five percent of their estimated long-run trend levels, the new proposal continues to rely on unadjusted MTM LTVs.

As FHFA acknowledges, using MTM LTVs is a pro-cyclical policy. Under FHFA's proposed parameters, house price levels would have pierced the lower boundary of the plus/minus five percent collar around the long-run trend line by the third quarter of 2016 but would not yet (through 2020-q1<sup>3</sup>) have exceeded the top end of that collar.<sup>4</sup> Meanwhile, over the past 3 ½ years, house prices have been soaring at an annual rate three percentage points faster than general price inflation. A strong seller's market developed during that period, clearly raising risks of a reversal, but had the proposed rule been in place, capital requirements would have gone down, not up as they should have.

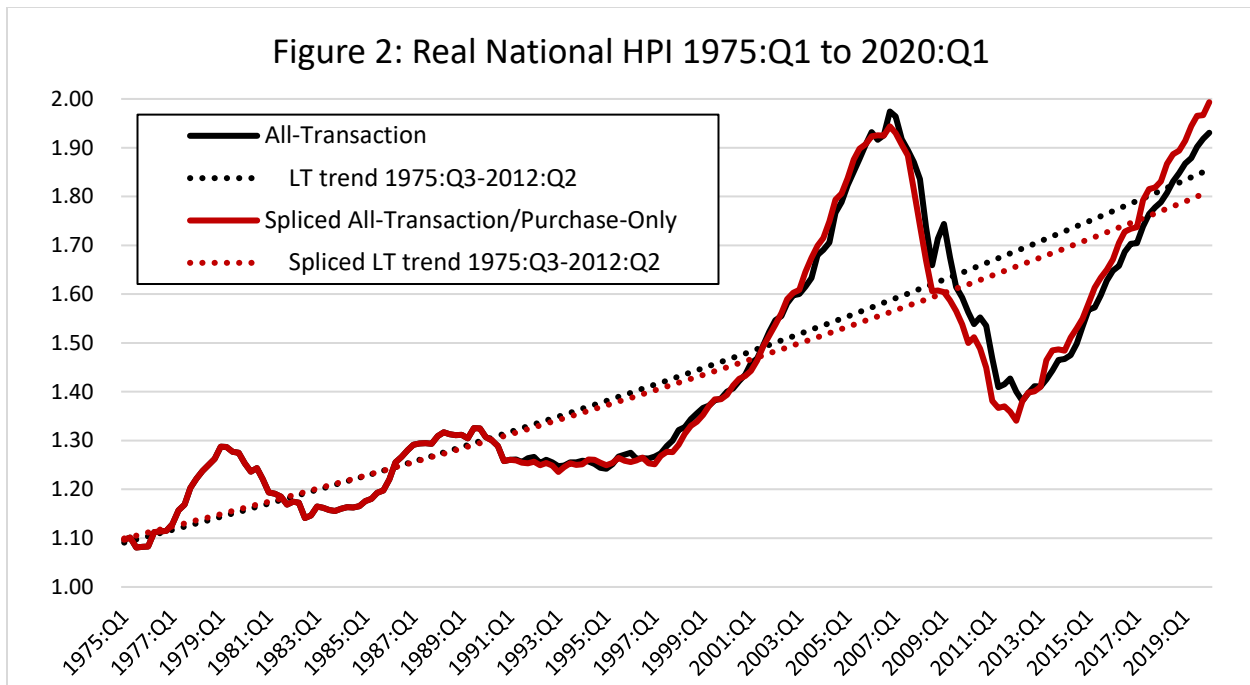
Second, FHFA's proposal does not make use of its best house price series. For purposes of calculating the countercyclical adjustment, FHFA estimates its trend real price series based on its All-Transactions HPI. That is convenient because the series runs a full 45 years from 1975-q1. However, FHFA replaced this series many years ago as the focus of its regular press releases discussing the latest data. Indeed, for measuring MTM LTVs, FHFA's proposal uses its Purchase-Only HPI, which avoids less reliable appraisal data from refinance transactions. While that series goes back only to 1991-q1, it can easily be spliced onto the All-Transactions data for earlier years. As shown by Figure 2, before 2008, the two series track each other well enough, but during the crash, the appraisals in the All-Transactions index slowed its decline, and since early 2012, the Purchase-Only index has risen faster and is now more than three percentage points higher, relative to the estimated trend, than the All-Transactions index. That is not insignificant, particularly in relationship to the 5 percent collar. In addition, the spliced index would have declined more rapidly during the crash, providing needed capital relief at just the right time. Using the spliced All-Transaction/Purchase-Only index to estimate the trend would have lowered the trend line, amounting to nearly a 3 percent difference by 2020-q1. The combined effect of changing to the superior Purchase-Only index would put the latest data six percent higher, relative to trend. Figure 2 below compares both the two different real price series and the two trend lines. In our comments two years ago, we recommended using purchase-only data where possible and continue to do so.

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<sup>3</sup> By mid-2015, the AEI Housing Center was already warning of a house price boom, while FHFA's proposed metric would have indicated that house prices were just getting back within the collar by 2016-q3. See for example: <https://www.aei.org/economics/housing-finance/fifty-years-of-housing-policy-failure/>

<sup>4</sup> Similarly during the last housing bust, house price levels would not have pierced the lower boundary of the plus/minus five percent collar until 2010:Q2, which is 3 years after home prices had peaked. Thus every time the cycle turns, the collar is much too slow to act counter-cyclically. In the absence of a collar, the MTM LTV would be adjusted by the ratio of the house price index to the long-term house price trend line for the current quarter.





Source: FHFA and AEI Housing Center.

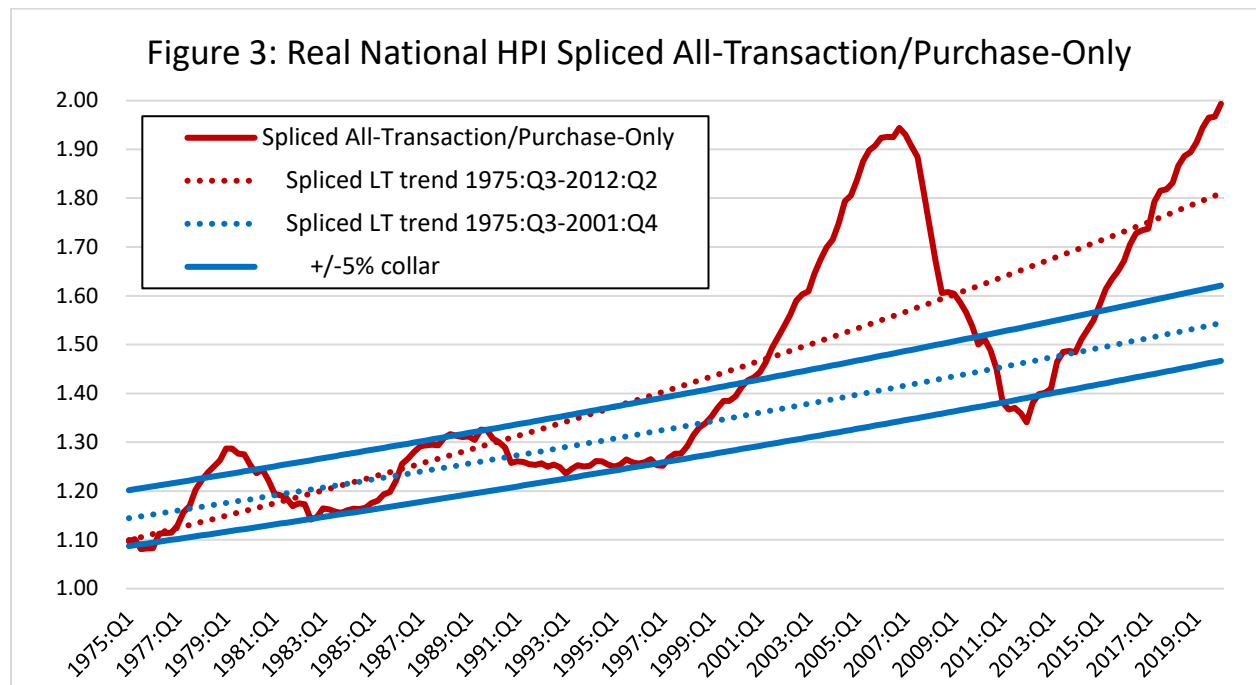
Third, FHFA chose to base its trend line on a period spanning the last three national house price cycles. While incorporating complete cycles has appeal, we think it important to recognize the extraordinary impact of the last cycle on the measured trend. The last cycle was not only much bigger, it also appears to us to be distinctly asymmetric. The peak was exceptionally outsized, sufficient to cause failures of the GSEs' and other major financial institutions. It was marked by an absence of meaningful policy efforts by regulators and supervisors to combat the boom. By contrast, the nadir of house prices was cushioned by truly heroic legislation and major policy actions. Consequently, a real house price trend estimated using pre-boom data is very different than that estimated by FHFA. In our comment two years ago, we recommended using data from 1975 to 2001, inclusive. We felt that represented a reasonably normal period. Figure 3 below shows both the real house prices (based on the spliced All-Transactions/Purchase-Only data) and the trend lines estimated for the two time periods.

Selecting an appropriate estimation period is challenging. Once chosen, it is important to commit to it through the next cycle because it is simply too easy to say "this time is different," so we don't really need to let requirements go up. It must also seem reasonable at the time of its initiation. In our view, the housing market in the early months of this year, after eight years of unsustainable price increases, especially in the lower price tiers, was decidedly beyond the "near normal" range. It is also worth considering that in 2001-q2, FHFA's real house price line shown above in Figure 1 was below its estimated trend line. That is despite the fact that, at that time, FHFA's predecessor thought it timely, to publish an analysis evaluating whether we were already in a price bubble.<sup>5</sup>

While we are not in favor of adding a collar for reasons described above, if FHFA were to implement one, we would strongly recommend combining it with the long-term trend estimation based on the period from 1975 to 2001, inclusive. As evidenced by Figure 3, the piercing of the upper collar roughly

<sup>5</sup> [https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2000Q4\\_hpi.pdf](https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2000Q4_hpi.pdf)

matches the date of FHFA’s predecessor’s study in 2001 and for the most recent boom, it roughly matches mid-2015, when the AEI Housing Center began warning of an impending boom.



Source: FHFA and AEI Housing Center.

### The Leverage Standard

We strongly support three changes to the leverage standard made in the 2020 version of the rule. First, the statutory core capital measure is effectively replaced by tier 1 capital, which eliminates amounts not likely to absorb losses. Second, the new proposal adopts the stronger of the two alternatives offered in the 2018 proposal (2.5 percent of assets). Third, the new proposal adds a 1.5 percent tier 1 buffer which provides a much more reasonable floor for capital. At 2019-q3, the total would be \$243 billion. That compares with actual peak losses (2008-11) of \$275 billion, or \$223 billion after removing the effects of DTAs and dividends paid to Treasury during that period, both of which would not be needed under the new proposal. That would leave a scant \$20 billion of capital to keep operating as a going concern--not nearly enough, but the leverage ratio is merely meant to set a floor.

As mentioned above, the very modest enforcement regime that applies to the buffer gives us some discomfort. While this approach has worked acceptably with banks so far, in view of the potentially stronger political position of the GSEs, we would urge FHFA to insert into the rule a provision stating that a failure to maintain the prescribed buffers except in extraordinary market conditions would be an unsafe and unsound practice.

### Further Comparisons with Banks

The new proposal adopts many good structural attributes of bank capital rules, and the addition of sizable capital buffers makes the proposed requirements much more comparable in magnitude, as well. However, FHFA’s new version still falls short of standards for bank holding companies, even considering

differences in asset riskiness. The table below uses data from the tables on pages 231 to 234 of the proposal for Fannie Mae and Freddie Mac on September 30, 2019 and data from JPMorgan Chase and Co.'s 2019 10-K on December 31, 2019 to compare required capital plus buffers for each of them, including the minimum amounts of each type of capital needed to satisfy all requirements.

### Capital Required Plus Buffers as a Percent of Adjusted Assets

Capital Type	Fannie Mae (2019-q3)	Freddie Mac (2019-q3)	JPM (2019-q4)
CET1	3.1%	2.6%	5.8%
Other Tier 1	0.9	1.4	0.9
Other Tier 2	0.1	0.0	1.1
Total	4.1	4.0	7.8

To meet its required capital plus buffers, Morgan needs nearly as much capital as two GSEs together (\$243 billion versus \$246 billion), even though its adjusted assets are less than half as large (\$2.73 trillion versus \$6.07 trillion). A small amount of the difference is accounted for by the GSEs' focus on single-family mortgages, which have a risk-weight of 50 percent for banks, compared with Morgan's average risk weight of 55 percent. The GSEs' average risk weight under the proposed rule is only 28 percent. The GSEs make important use of credit risk transfers while banks do not, and they make greater use than banks do of mortgage insurance and other credit enhancements, but the GSEs' capital reductions for those items only amounts to 46 basis points of adjusted assets. Adding 100 basis points more to required capital as we have recommended would certainly make the GSEs' capital more comparable.

The table also shows that the average quality of GSE capital would be similar. To minimally meet all standards, each of them would need to have at least about three-fourths of total mandated amounts in the form of common equity. The implications may be different for GSEs than for banks, though. In 2007 and 2008, the GSEs looked exclusively to preferred stock to raise what little they did raise. Heavy reliance on preferred stock adds to costs for troubled institutions, and it remains to be seen whether the GSEs' existing preferred stockholders will absorb the losses they were expected to in a financial failure.

With respect to other tier 2 capital, it would not be of much help to the GSEs unless the risk-based requirement was significantly higher. Given the low quality of these instruments, especially subordinated debt as discussed above, perhaps it would better to simply eliminate them, making adjusted total capital and tier 1 identical.

Another way FHFA has made the GSE rule more comparable to bank rules is the explicit treatment of systemic risk. The 2008-9 experience illustrated powerfully the systemic importance of Fannie Mae and Freddie Mac. The Dodd-Frank Act provides specific regulatory regimes for the largest banks and non-bank financial institutions. When released from conservatorship, the GSEs could be designated as systemically important non-bank financial institutions (SIFIs), but that would create a duplicative regulatory structure, making FHFA of marginal relevance, without addressing the substance of the problem. FHFA's new proposal establishes three capital buffers that do so. The stress buffer of 75 basis points recognizes the need for the GSEs to be able to function as going concerns during and after a crisis. The stability buffer is targeted at the consequences of a GSE's failure on the liquidity, efficiency, competitiveness, and resiliency of financial markets. It is based on a GSE's market share and would have

amounted in September 2019 to 1.05 percent and 0.64 percent of assets for Fannie Mae and Freddie Mac, respectively. Finally, the countercyclical buffer (separate from the countercyclical adjustment discussed above) would potentially address excess aggregate credit growth and the buildup of systemic risk. FHFA states that the latter buffer would likely be tied to the exercise by bank regulators of their option to use a comparable bank buffer. Given their failure to do so in the heated pre-pandemic conditions (including soaring financial asset prices, a dangerous leveraged loan market, and booming housing markets fueled by easy-access mortgages), the countercyclical buffer may have limited value.

### **Summary**

FHFA's revised proposal is a significant advance over its 2018 version. The risk-based requirements are still too low in three areas. A model risk requirement of 50 basis points is needed to reflect the inevitable unforeseen changes to risks, almost always upward, not incorporated in the models used to set risk weights of the various mortgage products and credit enhancements. Operational risk still needs at least another 10 basis points, and the cyclical adjustments need to be expanded to encompass vibrant markets such as those in the past few years to avoid a perverse weakening in capital while risks have been rising. To ensure that the buffers will result in real capital, FHFA should strengthen its language regarding enforcement of them by putting it directly in the rule rather than just in the explanatory text. The quality of capital in the new proposal has improved, but even greater emphasis on common equity would be better.