GRAHAMFISHER

June 12, 2018

Joshua Rosner
646/652-6207
jrosner@graham-fisher.com
Twitter: @joshrosner

FHFA's Proposed Capital Rule: a Good Start

In its release of proposed Enterprise Capital Rules, the Federal Housing Finance Agency ("FHFA") finally exercised one of the directives required by the Housing and Economic Recovery Act of 2008. In a 368-page document the Agency offered a thoughtful, thorough and exceptionally well-reasoned proposal that would ensure the GSEs hold sufficient capital, and that they be constrained to an appropriate leverage ratio, to withstand any possible and foreseeable housing downturn. We believe that the capital rules are appropriately conservative, while not being so onerous as to reduce the economic viability of their mandated mission to ensure liquidity to the primary mortgage market. Still, there are several points that must be made regarding this effort. Most specifically, it is not enough to determine the amount of capital that the GSEs must hold, the FHFA has a statutory responsibility to require the GSEs to submit "capital restoration plans" and to approve or deny such a plan. Furthermore, the proposed rule notes that FHFA will not implement the capital requirements while the GSEs are in Conservatorship and will, instead, wait for Congress or the Administration to affirmatively act on GSE reform. Such a position is in direct opposition to the requirements of the HERA law and, again, ignores that Congress has acted and given it direction in the HERA law.

The Capital Requirements:

The proposed rule is quite complex and considers the type of assets, the credit quality of assets, the liquidity risks of assets, the risk transfer benefits, the type of mortgage insurance, the risk counterparties and other key considerations including an "ongoing concern buffer", "market risk" and operational risk" considerations. Still, the proposed rule can be most easily summed up by the following statement:

"Under the first alternative, the "2.5 percent alternative," the Enterprises would be required to hold capital equal to 2.5 percent of total assets (as determined in accordance with generally accepted accounting principles (GAAP)) and off-balance sheet guarantees related to securitization activities, regardless of the risk characteristics of the assets and guarantees or how they are held on the Enterprises' balance sheets. Under the second alternative, the "bifurcated alternative," the Enterprises would be required to hold capital equal to 1.5 percent of trust assets and 4 percent of non-trust assets, where trust assets are defined as Fannie Mae mortgage-backed securities or Freddie Mac participation certificates held by third parties and off-balance sheet guarantees related to

securitization activities, and non-trust assets are defined as total assets as determined in accordance with GAAP plus off-balance sheet guarantees related to securitization activities minus trust assets. The Enterprises' retained portfolios would be included in non-trust assets."

Applying these two approaches to the GSEs the capital requirements, at the end of 2017, would be as follows:

Table 5: Fannie Mae and Freddie Mac Estimated Risk-Based Capital Requirements as of September 30, 2017 – by Risk Category

	Fannie Mae Capital Requirement			Freddie Mac Capital Requirement			Enterprises' Combined Capital Requirement		
	$billions	bps	Share, %	$billions	bps	Share, %	$billions	bps	Share, %
Net Credit Risk	$70.5			$41.5			$112.0		
Credit Risk Transferred	($11.5)			($10.0)			($21.5)		
Post-CRT Net Credit Risk	$59.0	176	51%	$31.5	142	48%	$90.5	162	50%
Market Risk	$9.5	28	8%	$9.9	44	15%	$19.4	35	11%
Going-Concern Buffer	$24.0	72	21%	$15.9	71	24%	$39.9	72	22%
Operational Risk	$2.6	8	2%	$1.7	8	3%	$4.3	8	2%
Other (DTA) *,**	$19.9	59	17%	$6.8	31	10%	$26.8	48	15%
Total Capital Requirement	$115.0	343	100%	$65.9	296	100%	$180.9	324	100%
Total Assets and Off-Balance Sheet Guarantees, $billions	$3,353.1			$2,226.0			$5,579.0		

** The DTA capital requirement is a function of Core Capital. Both Enterprises have negative Core Capital as of September 30, 2017. In order to calculate the DTA capital requirement, we assume Core Capital is equal to the Risk-Based Capital Requirement without consideration of the DTA capital requirement.*

*** Both Enterprises' DTAs were reduced in December 2017 as a result of the change in the corporate tax rate. The risk-based capital requirement for DTAs as of December 31, 2017 would be $10.0 billion or 30 bps for Fannie Mae and $1.2 billion or 5 bps for Freddie Mac. See Table 33 and Table 34 for more detail.*

So, What's the Problem?

While we applaud FHFA's promulgation of this proposed rule we are nonetheless concerned that the Director has continued in the footsteps of his predecessor and has chosen which of its legal mandates, defined in HERA, on which it has chosen to act.

FHFA's Position is in Clear Violation of the Spirit and Letter of Law:

On page 12 of the proposed rule, FHFA states: "FHFA's position continues to be that it is the role of Congress and the Administration to determine the future of housing finance reform and what role, if any, the Enterprises should play in that system." This view, while deferential, ignores the undisputable fact that Congress and the White House signed the Housing and Economic Recovery Act ("HERA") into law, thus stating their explicit position – a position that must be followed unless and until Congress and the White House pass a new law supplementing or superseding HERA.

Capital Classifications (HERA Section 1142):

Section 1142 of HERA, referring to Section 4614 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, explicitly requires that the FHFA promulgate capital classification rules for the GSEs and the Home Loan Banks. On page 19 of the proposed rule FHFA notes that "On September 6, 2008, the Director of FHFA appointed FHFA as the conservator for each Enterprise…suspended the capital classifications and the regulatory capital requirements applicable at that time, and they remain suspended." Nowhere in HERA is such suspension of the capital classifications authorized. Instead, Director Watt is continuing to effect clear violations of the Act made by his predecessors.

Restrictions on Capital Distributions (HERA Section 1142) :

HERA plainly states: "A regulated entity shall make no capital distribution if, after making the distribution, the regulated entity would be undercapitalized." Still, the Conservator has affirmatively directed the GSEs to continue to pay dividends on their senior preferred stock to the Treasury. While FHFA justifies these actions as conforming with the PSPA, there is nothing in the law that provides that a contract between the GSEs, FHFA and the Treasury supersede the law. HERA retains the definition of "capital distribution" found in Section 4502 of the 1992 Safety and Soundness Act.[1]

Coordination with US Treasury (HERA Section 1367):

Although FHFA's deference to Treasury, and its consideration of the Treasury's line of financing contracted for in the PSPA's is commendable, it ignores the intent of Section 1367 of HERA which authorizes FHFA to "take such action as may be necessary to put the regulated entity in a sound and solvent condition; and appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity." In fact, knowing that political considerations could impair the operation of the FHFA, as a prudential regulator, HERA explicitly states: "When acting as conservator or receiver, the Agency shall not be subject to the direction or supervision of any other agency of the United States or any State in the exercise of the rights, powers, and privileges of the Agency."

---

[1] The term ''capital distribution'' means— (i) any dividend or other distribution in cash or in kind made with respect to any shares of, or other ownership interest in, an enterprise, except a dividend consisting only of shares of the enterprise; (ii) any payment made by an enterprise to repurchase, redeem, retire, or otherwise acquire any of its shares, including any extension of credit made to finance an acquisition by the enterprise of such shares; and (iii) any transaction that the Director determines by regulation to be, in sub- stance, the distribution of capital.

Capital Restoration Plans (HERA Section 1313B):

It is not enough to state how much capital the GSEs need, HERA directs FHFA to require undercapitalized enterprises to limit any new activities, asset growth (Section 1143) and even funding of the affordable housing trust funds (Section. 1337), until the GSEs have submitted "capital restoration plans" and those plans have been approved by the Conservator.

Capital (HERA Section 1143):

HERA explicitly states that "An undercapitalized regulated entity shall not permit its average total assets during any calendar quarter to exceed its average total assets during the preceding calendar quarter, unless: the Director has accepted the capital restoration plan of the regulated entity; any increase in total assets is consistent with the capital restoration plan; and the ratio of tangible equity to assets of the regulated entity increases during the calendar quarter at a rate sufficient to enable the regulated entity to become adequately capitalized within a reasonable time." Director Watt appears to be continuing to follow the extra-legal position of former Acting Director DeMarco by relying on the argument that the GSEs do not need capital because of the lines of financing provided by the US Treasury and formalized in the Preferred Stock Purchase Agreement (PSPA). These lines are not capital under any applicable legal or accounting standard as the capital is not on the GSEs balance sheet. As the CBO has made clear: "*Equity capital is assets minus liabilities… The greater a firm's equity capital, the greater its capacity to sustain losses and continue operating. The public interest is served by restricting the risks that Fannie Mae and Freddie Mac assume and by requiring those enterprises <u>to hold capital</u> commensurate with the risks they retain*."[2] (emphasis added)

Not only are the Treasury lines of financing not capital, the Net Worth Sweep which the last Administration tied to those lines is the exact opposite of capital because it drains the excess of assets over liabilities, i.e. the net worth. It should never have been approved by a safety-and-soundness regulator whose mandate, under the law, is to ensure the maintenance of adequate capital, let alone instituted by a conservator in the case of an undercapitalized financial institution. It is a rejection and perversion of the fundamental concept of safety-and-soundness regulation at the very heart of our financial system.

---

[2] Congressional Budget Office, "Equity Capital and the Capacity to Bear Risks", Dan L. Crippen, Director, January 3, 2003, Letter to Honorable Paul S. Sarbanes Chairman, Committee on Banking, Housing, and Urban Affairs

New Activities and the Common Securitization platform (HERA Section 1143):

HERA makes it clear that: "An undercapitalized regulated entity shall not, directly or indirectly, acquire any interest in any entity or engage in any new activity, unless: the Director has accepted the capital restoration plan of the regulated entity, the regulated entity is implementing the plan, and the Director determines that the proposed action is consistent with and will further the achievement of the plan." On page 32 of the proposed rule FHFA states: "FHFA's conservatorship strategic plan has three goals: 1) to maintain foreclosure prevention activities and new credit availability in a safe and sound manner, 2) to reduce taxpayer risk through increasing the role of private capital, and 3) to build a new securitization infrastructure…implementation of the common securitization platform and single security." Here too Director Watt has followed former Acting Director DeMarco in violating the plain language of the law, by allowing activities prohibited in the absence of a capital restoration plan.

Conclusion:

While FHFA's proposed Enterprise Capital Rule is a laudable effort to execute on explicit requirements in HERA it is not enough. On page 12 of the proposed rule FHFA takes the position that: "The fact that FHFA has suspended the Enterprises' capital requirements does not eliminate FHFA's responsibility, as a prudential regulator, to articulate a view about Enterprise capital requirements". In fact, as made explicitly clear in HERA, FHFA's responsibility as a prudential regulator is not to "articulate a view" but, instead, to take such actions as necessary to ensure the safety and soundness of the GSEs in a manner that protects the financial exposure of taxpayers.

Ten years after they were placed in Conservatorship the GSEs have nothing more than a \$3 billion capital buffer. FHFA's capital rule calculates the GSEs need \$154.1 billion of capital (excluding the deferred tax assets). For FHFA to ignore its clear responsibilities under HERA, and to leave taxpayers fully exposed to potential future losses of up to \$154.1 billion is not only not prudent but it is an unsafe and unsound decision by a regulator who possesses all of the necessary authorities, in law, to require the GSEs to build larger capital buffers.