Comparison of FHFA Proposed Rule on Enterprise Capital Framework to Final Rule

Q4 2020

SFA Comparison of Proposed ECF to Final ECF

While some modest changes were incorporated, the Final Rule fails to address threshold concerns raised by SFA members

Changes built into the Final Enterprise Capital Framework

SFA recommended that implementation of the Final Enterprise Capital Framework ("ECF") be suspended until important threshold questions about the GSEs and their status in conservatorship were answered

- In SFA's response to the FHFA's Proposed ECF, we noted that the proposed rule not only established parameters for capital levels and how capital relief would be afforded to Fannie Mae and Freddie Mac (the government-sponsored enterprises or "GSEs"), but also effectively laid out a roadmap for the GSEs to be recapitalized and released from conservatorship without also providing clarity on a number of paramount policy issues.
- SFA detailed the many important threshold policy questions that must be answered before the GSEs can safely be released from conservatorship, such as whether there will be a full faith and credit guaranty on legacy and new-issue agency MBS in place before the GSEs exit conservatorship. SFA cautioned that even the appearance of the ECF functioning as a recapitalization and release plan would create turmoil in the market. We therefore urged suspension of the implementation of the rule to avoid such turmoil and allow these important questions to first be answered.
- However, now that the final rule will go into effect before any further consideration of such threshold questions, it is clear that the current FHFA leadership likely plans to use the Final ECF as a roadmap out of conservatorship. If the status of the GSEs' relationship with the U.S. Government is unclear upon release from conservatorship, this will affect TBA pricing and liquidity, cause uncertainty for investors, and destabilize the secondary market in contravention of the charters of the GSEs
- Therefore, before even addressing questions embedded in the rule on the adequacy and different types of capital, the Final ECF failed to alleviate concerns that the FHFA is rushing the release of the GSEs in favor of calendar-driven political interests.

SFA recommended that CRT remain an economically viable means of offloading credit risk from GSEs

- Relative to the Proposed ECF, the Final ECF does afford Credit Risk Transfer ("CRT") transactions a slightly more viable means for the GSEs to transfer credit risk.
- However, the final rule harms the economics of all methods of risk transfer by increasing the credit risk floor for mortgage related assets from 15% to 20%. While the benefit afforded CRT is slightly improved in the Final ECF relative to the Proposed ECF on an absolute dollar benefit, this improvement takes place in an overall environment where the economics of all forms of risk transfer are adversely impacted by the 20% floor
- Other issues with the approach of increasing the credit risk floor of all mortgage assets to 20% include incentivizing the GSEs to "lever up" on the riskiest loans and disincentivizing less-risky loans (FHFA estimates the floor would impact 55% of GSEs' current book of business), and shifting substantial volume to FHA/VA.

Key Takeaway: Considering the two overarching issues of most importance to SFA members—addressing crucial outstanding policy issues prior to using the ECF as a roadmap out of conservatorship and ensuring the continued economic viability of GSE CRT programs—the Final ECF does not alleviate existing concerns, and instead raises more questions about the purpose and ultimate effects of the ECF.

Additional Concerns Raised by SFA Members

- By raising the credit risk floor on all mortgage-related assets from 15% to 20%, in the Final ECF, the leverage ratio is no longer the binding constraint. As noted above, increasing this floor has other ripple effects across the housing finance system.
- The Final Rule frequently notes the superiority of equity capital to all other forms of capital. However, industry analysis suggests that such capital will only come by raising the return on equity, which cost will be directly passed on to borrowers in the form of higher rates (current estimates are between 20-30 basis points).
- The Final Rule purports to create transparency in how the GSEs' credit counterparties are assessed, but there are concerns that the criteria and evaluation of such assessments remain opaque and leave industry stakeholders without adequate recourse.
- The Final ECF also mitigates some concern raised about the pro-cyclicality of utilizing home price appreciation by introducing a trigger when home price appreciation is more than 5 percent above their long-term trend. When the 5 percent threshold is reached, it triggers the single-family countercyclical adjustment to mark-to-market loan-to-value ("MTMLTV") requirements. Additionally, the Final ECF introduces lender risk-sharing as a form of credit risk transfer which achieves capital relief. More analysis is needed to determine the overall impact of these provisions of the final ECF.

- Overall, industry participants have noted that the rule remains overly complex, and unresponsive to the most pressing industry concerns that have been raised.

- Key Takeaway: While FHFA has been responsive to some feedback provided by the industry, the Final ECF remains opaque and complex, without a thorough understanding or analysis of how the market will ultimately be impacted. The opacity of the rule risks leaves many important questions overlooked or unanswered. Moreover, as detailed in our Letter to Treasury Secretary Mnuchin[1], simply having an ECF in place does in and of itself create the preconditions necessary for an orderly transition for the GSEs to be released from conservatorship.

[1] *See* https://structuredfinance.org/resource-details/sfa-letter-to-treasury-on-pspas-releasing-gses-from-conservatorship-prematurely/