

BI Regulation Watch: GSE Capital Requirements

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Fannie, Freddie Capital Rule Portends Supercharged Private GSEs

(Bloomberg Intelligence) -- FHFA's proposed GSE capital rule signals the Trump administration is planning for Fannie Mae and Freddie Mac to return to private shareholders. The June proposal requires much less capital relative to banks and makes key concessions for credit-risk transfers. If the companies exit their decade-long conservatorship subject to this rule, they'll be incentivized to grow. (10/29/18)

1. What's at Stake for Fannie and Freddie?

Fannie and Freddie's continued duopoly.

The Federal Housing Finance Agency's capital proposal would ensure that Fannie and Freddie maintain dominant market share if they exit conservatorship as going concerns. Its risk-based capital requirement would act as the primary binding constraint, incentivizing the GSEs to pursue additional revenue from their retained portfolios of mortgages, mortgage-backed securities and other assets. They could hold more mortgage risk on their books while holding less capital relative to banking peers. (10/29/18)

Proposed Capital: Fannie 3.4%, Freddie 3%

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 3 bps for Freddie Mac. See Table 33 and Table 34 for more detail.

Source: "Enterprise Capital Requirements," FHFA, 7/17/2018, Pg. 71

2. What's at Stake for Mortgage Originators?

Greater dependence on Fannie, Freddie.

If the government-sponsored enterprises could again add risk subject to a unique, favorable capital regime, mortgage originators would be along for the ride. FHFA's capital plan encourages risk-taking throughout the cycle, raising demand for mortgages. Banks and affiliates couldn't competitively hold whole loans, so only new rival guarantors could threaten the duopoly. Access to the common securitization platform would reduce barriers to entry, but Fannie and Freddie's moat would be formidable. (10/29/18)

PLS Comeback If Fannie, Freddie are Buyers?

Table 25: Fannie Mae and Freddie Mac Combined Estimated Risk-Based Capital Requirements for Private-Label Securities as of September 30, 2017

	Capital Requirement		
	\$billions	bps	Share, %
Credit Risk	\$2.2	1,502	64%
Market Risk	\$1.1	767	33%
Going-Concern Buffer	\$0.1	60	3%
Operational Risk	\$0.01	6	0%
Total Capital Requirement	\$3.4	2,336	100%
Total UPB, \$billions	\$14.4		

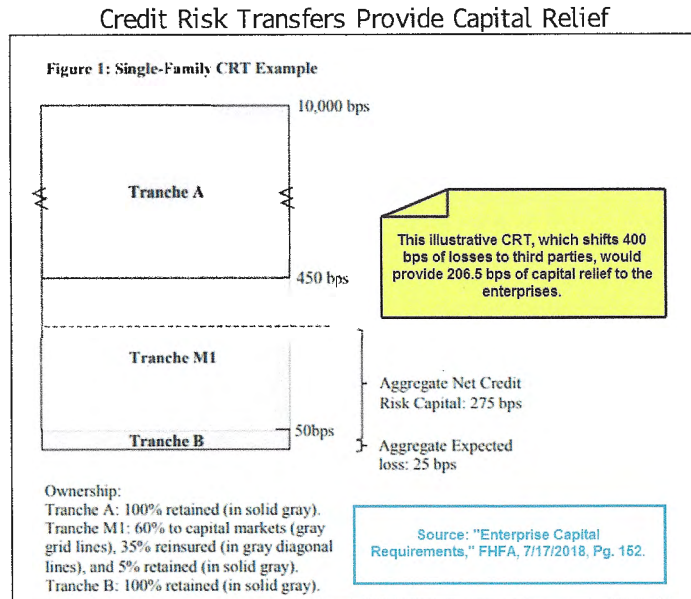
Note: Post-conservatorship, FNMA/FMCC could hold private-label securities with far fewer loss-absorbing resources in place relative to commercial banks.

Source: "Enterprise Capital Requirements," FHFA, 7/17/2018, Pg. 166.

3. What's the Outlook?

Fannie, Freddie poised for growth.

Fannie and Freddie would grow if released from conservatorship and governed by FHFA's new proposal. The plan, in our view, increases the odds that the Trump administration attempts to release the companies to shareholders. The proposal's capital relief for new credit risk transfer transactions could be especially favorable, allowing the GSEs to flourish with less capital. Fannie and Freddie would gain regulatory advantages over banks, given assets tend to flow toward the lowest cost of capital. (10/29/18)



4. What's Next?

Comment period ends in November.

FHFA Director Mel Watt's term ends in early 2019, meaning President Donald Trump's chosen successor will likely finalize the rule. While government-sponsored enterprises remain in conservatorship, their agreements with Treasury, not this proposal, govern capital requirements. This rule informs and updates how FHFA manages the GSEs' capital while in conservatorship. The plan, reflecting the Trump administration's views on GSE capital, isn't likely to change substantially before being finalized. (10/29/18)

Next Key Event:

- Comment Period Ends
- November 16, 2018

Last Key Event:

- Published in Federal Register
- June 17, 2018

5. What's the Issue?

Fannie, Freddie capital requirements.

At this point, the proposal is a thought experiment to help FHFA plan for a possible future when Fannie and Freddie exit conservatorship. The effort also lays the groundwork for successor guarantors, if Congress were to wind down the GSEs. Under the proposal, Fannie would need \$115 billion and Freddie \$66 billion, as of September 2017. The rule is calibrated such that it would have required enough capital in 2007 to cover Fannie Mae and Freddie Mac's "peak cumulative losses" of \$265 billion. (10/29/18)

Rule Documents:

- [Enterprise Capital Requirements Proposed Rule | MMDL](#)

Industries Impacted:

- Mortgage guarantors Fannie Mae and Freddie Mac
- Mortgage originators including JPMorgan, Bank of America, Wells Fargo, Quicken Loans, U.S. Bancorp
- Mortgage insurers including Arch Capital, Essent, Genworth, MGIC, Radian, United Guaranty

Government Entity:

- Federal Housing Finance Agency (FHFA)

6. What Else?

Everything is still on the table.

FHFA's capital rule makes the case that the GSEs can weather a financial crisis on the magnitude of 2008's, especially with fixes to treatment of deferred tax assets that exacerbated losses. The proposal implicitly prepares Fannie and Freddie to exit conservatorship, despite FHFA's assertions to the contrary. Other options on the table -- including the Basel III standardized approach, which generally requires more capital and are less favorable to the GSEs -- won't appeal to Watt's successor. (10/29/18)

DTA Treatment Fixes Major 2008 Issue of DTA Losses

Table 33: Fannie Mae and Freddie Mac Estimated Risk-Based Capital Requirements for Deferred Tax Assets Assuming Core Capital Equal to Risk-Based Capital Requirement*

	As of September 30, 2017 (in \$billions)			As of December 31, 2017 (in \$billions)		
	Fannie Mae	Freddie Mac	Total	Fannie Mae	Freddie Mac	Total
Category 1	\$2.5	\$1.4	\$3.9	\$2.5	-	\$2.5
Category 2	\$15.3	\$4.0	\$19.3	\$5.6	-	\$6.6
Category 3	\$1.9	\$1.2	\$3.0	\$1.8	\$0.9	\$1.8
Category 4	\$0.3	\$0.3	\$0.5	-	\$0.3	\$0.3
Total Capital Requirement	\$19.9	\$6.8	\$26.8	\$10.0	\$1.2	\$11.2

*The DTA capital requirement is a function of Core Capital. Both Enterprises have negative Core Capital as of September 30, 2017 and December 31, 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.

Category 1: 100 percent of DTAs arising from net operating losses and tax credit carryforwards, net of any related valuation allowances and net of DTLs.

Category 2: 100 percent of DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of related valuation allowances and net of DTLs that exceed 10 percent of adjusted core capital. Adjusted core capital is core capital, per the statute, less DTAs that arise from net operating losses and tax credit carryforwards, net of any related valuation allowances and net of deferred tax liabilities.

Category 3: 20 percent of DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of related valuation allowances and net of DTLs that do not exceed 10 percent of adjusted core capital.

Category 4: 8 percent of DTAs arising from temporary differences that could be realized through net operating loss carrybacks, net of related valuation allowances and net of DTLs.

Source: "Enterprise Capital Requirements," FHFA, 7/17/2018, Pg. 210.

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