SQUIRE PATTON BOGGS

What Is the Right Amount of Capital for Fannie Mae and Freddie Mac?

The answer depends upon whom you ask. In an earlier issue of this publication, I summarized a proposed capital framework for Fannie Mae and Freddie Mac (the Enterprises) that the Federal Housing Finance Agency (FHFA) released for public comment this past July[1].

The comment period has now ended, and the comments submitted highlight a tension between advocates for capital requirements that captures the systemic risk posed by the Enterprises and advocates for capital requirements that do not overly constrain mortgage credit.

A comment letter submitted by the Center for Responsible Lending (CRL) highlights one side of this issue. CRL claims that FHFA's proposal fails to fully recognize the changes in mortgage markets and the regulation of mortgages that has occurred since the 2008 financial crisis, and fails to take into account resources available to absorb losses in future crisis, such as deferred tax assets and ongoing revenue. As a result, CRL concludes that the proposal "substantially overestimates" the amount of capital needed, and would place an unfair burden on working families.

Mortgage insurers express a similar concern. A letter submitted by US Mortgage Insurers (USMI) asserts that the proposed capital rule contains elements of conservatism that, when taken as a whole, appear excessive based upon the business model of the Enterprises, which, according to USMI, is more akin to the business of insurance than the business of banking.

Conversely, the Housing Policy Council (HPC) concludes that the systemic risk posed by the Enterprises is greater today than it was at the start of the conservatorship as a result of their overall growth in their assets, the scope of their activities and their role as quasi-regulators of other participants in the housing finance market. HPC recommends that in addition to the various capital charges included in the proposal, FHFA either incorporate a systemic risk charge (or charges) or pursue changes in the scope of the operations and activities of the Enterprises.

Similarly, the American Bankers Association (ABA) calls on FHFA to consider the adoption of a capital charge based upon the concentration risk posed by the Enterprises. ABA notes that no large banking organization would be allowed to operate when it is so thinly capitalized. Yet, ABA acknowledges that there is a "necessary balance" between an ideal capital structure that protects taxpayers from the risks posed by the Enterprises and a regime that protects taxpayers "adequately" while also extending a benefit to potential homebuyers.

In addition to the need for FHFA to find the right "balance" in the capital requirements, several commenters expressed a concern over the pro-cyclical nature of the proposal and call on FHFA to incorporate provisions to offset this impact. HPC, for example, calls for FHFA to include a counter-cyclical adjustment to the risk-based charges based upon fluctuations in housing prices.

Several commenters also noted that it was difficult to respond fully to the proposal because most of the assumption, models and data build in to the proposal have not been revealed by FHFA. Accordingly, the Mortgage Bankers Association, USMI and HPC call upon FHFA to release this information and invite further comment on the proposal before any final rule is issued.

To be clear, any final rule that is issued while the Enterprises remain in conservatorship will not be implemented because FHFA has suspended application of capital requirements during the conservatorship. Nonetheless, a final rule would provide transparency into FHFA's views about the appropriate level of capital for the Enterprises and would position FHFA to impose new capital standards on the Enterprises, or their successors, whenever the conservatorship ends.

Contact

James C. Sivon
Of Counsel, Washington DC
T +1 202 262 4271
E james.sivon@squirepb.com

[1] www.squirepattonboggs.com/~/media/files/insights/publications/2018/07/our-perspectives/ghfa-capital-proposal/fhfacapitalproposalalert.pdf?la=en.

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