

FEDERAL HOUSING FINANCE AGENCY

12 CFR Part 1252

RIN 2590-AA22

Portfolio Holdings

AGENCY: Federal Housing Finance Agency.

ACTION: Final Rule; response to comments on the Interim Final Rule.

SUMMARY: The Federal Housing Finance Agency (FHFA) is issuing a final regulation that will govern the portfolio holdings of Fannie Mae and Freddie Mac (collectively, the Enterprises) during the pendency of the conservatorships. The final regulation adopts FHFA's interim final rule on portfolio holdings, without change. See 74 FR 5609, January 30, 2009. That interim rule adopted the portfolio limits specified in each Enterprise's Senior Preferred Stock Purchase Agreement (PSPA) with the Department of the Treasury (Treasury) as the regulation limits. Specifically, it provides that each Enterprise comply with the portfolio limits contained in the respective PSPAs, as they may be amended from time to time. The interim regulation also stipulated that the regulation is to be in effect until amended or the Enterprises are no longer subject to the PSPAs.

DATES: Effective [DATE OF PUBLICATION IN FEDERAL REGISTER], the interim final rule published on January 30, 2009 (74 FR 5609), which was effective January 30, 2010, is confirmed as final.

FOR FURTHER INFORMATION CONTACT: Ming-Yuen Meyer-Fong, Office of the General Counsel, (202) 414-3798, or Valerie Smith, Office of Policy Analysis and Research, (202) 414-3770, Federal Housing Finance Agency, 1700 G Street NW., Washington, DC 20552. The telephone number for the Telecommunications Device for the Deaf is (800) 877-8339. For more information on this Final Regulation, see the **SUPPLEMENTARY INFORMATION** section of this document.

SUPPLEMENTARY INFORMATION:

I. Background

A. Federal Housing Finance Agency and Recent Legislation

On July 30, 2008, the Housing and Economic Recovery Act (HERA) (Pub. L. 110–289, 122 Stat. 2564) was signed into law. Among other things, HERA established FHFA as a new independent agency and transferred the supervisory and oversight responsibilities for Fannie Mae and Freddie Mac from the Office of Federal Housing Enterprise Oversight (OFHEO) to FHFA. HERA amended the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Safety and Soundness Act), Pub. L. 102–550 (codified at 12 U.S.C. 4501 et seq.). The Safety and Soundness Act required FHFA to establish criteria, by regulation, governing the portfolio holdings of the Enterprises. 12 U.S.C. 4624. The purpose of such regulation is to ensure that the portfolio holdings are backed by sufficient capital and consistent with the mission and the safe and sound operations of the Enterprises. 12 U.S.C. 4624(a). In establishing criteria governing the portfolio holdings of the Enterprises, the Safety and Soundness Act directed FHFA to consider the ability of the Enterprises to provide a liquid secondary

market through securitization activities, the portfolio holdings in relation to the overall mortgage market, and adherence to standards of prudential management and operations established by FHFA in accordance with section 1313B of the Safety and Soundness Act. 12 U.S.C. 4624. The Safety and Soundness Act further required that any criteria governing Enterprise portfolio holdings ensure that such holdings be consistent with the Enterprises' mission, which includes facilitating the financing of affordable housing for low- and moderate-income families in a manner consistent with their overall public purposes. 12 U.S.C. 4624(a); 12 U.S.C. 4501(7).

B. The Enterprises, Generally

Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs) chartered by Congress for the purposes of establishing secondary market facilities for residential mortgages. 12 U.S.C. 1716 et seq. (Fannie Mae Charter Act) and 12 U.S.C. 1451, et seq. (Freddie Mac Corporation Act). Specifically, Congress established the Enterprises to provide stability in the secondary market for residential mortgages, respond appropriately to the private capital market, provide ongoing assistance to the secondary market for residential mortgages, and promote access to mortgage credit throughout the country. 12 U.S.C. 4624(b).

The Enterprises grew rapidly during the late 1990s into the early 2000's—nearly doubling their combined net holdings of mortgage assets from 1996 to 1999 and more than tripling those net holdings from 1996 to 2002. Accounting and other internal control issues caused the Enterprises to slow the growth of, and in the case of Fannie Mae, shrink, their mortgage asset portfolios after 2003. Because of increased operational risk, OFHEO, predecessor to FHFA, imposed on each Enterprise a 30 percent capital

surcharge, and in mid-2006, the Enterprises agreed to cap the growth of their mortgage portfolio holdings due to their accounting, internal control, and risk management weaknesses.

At the end of 2009, the Enterprises had combined assets of just over \$1.7 trillion and combined mortgage assets of approximately \$1.5 trillion. At that time, the Enterprises guaranteed the credit risk of mortgage loans backing nearly \$3.9 trillion of mortgage-backed securities (MBS). In total, Fannie Mae and Freddie Mac owned and guaranteed approximately 46.7 percent of the nation's residential mortgage debt outstanding as of the end of 2009.

C. Establishment of the Conservatorships

The U.S. housing markets began deteriorating in mid-2007, and the deterioration continued throughout 2008. The price volatility and liquidity problems in financial markets that ensued led to sizeable credit and market losses at both Enterprises, depletion of their capital, and an inability of the Enterprises to raise new capital and to access debt markets in their customary way. Significant safety and soundness issues and risk that the Enterprises would be unable to fulfill their missions caused FHFA, with the concurrence of the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve, on September 6, 2008, to place the Enterprises into conservatorship. By board approval, each Enterprise consented to the appointment of a conservator. The goals of FHFA in placing the Enterprises into conservatorship included enhancing the capacity of each Enterprise to fulfill its mission of providing liquidity and stability to the mortgage markets and mitigating the systemic risk which each poses and which had contributed to instability in mortgage and broader financial markets.

Critical to the establishment of the conservatorships were the actions taken at the same time by the Treasury—consistent with its authority granted in HERA—to provide ongoing financial support to the Enterprises to ensure they remain active participants in the marketplace. Upon establishment of conservatorships for the Enterprises, FHFA acting on behalf of each Enterprise entered into separate PSPAs with the Treasury on September 7, 2008. The PSPAs prevent Enterprise capital from being exhausted and are the cornerstone of the financial support that the Treasury is providing to Fannie Mae and Freddie Mac. Under the PSPAs, each Enterprise’s business operations was fortified through an initial commitment by the Treasury to acquire up to \$100 billion of senior preferred stock in each Enterprise as necessary to ensure that the Enterprise avoids a negative net worth, determined in accordance with generally accepted accounting principles.

In return for the support provided through the PSPAs, Fannie Mae and Freddie Mac provided certain compensation to the Treasury and accepted various restrictions. The compensation to the Treasury initially included the issuance by each Enterprise of \$1 billion in senior preferred stock and warrants for the purchase of common stock representing 79.9 percent of its outstanding common stock. In addition, the Enterprises agreed to limitations on their business activities. In particular, while the PSPAs do not restrict how each Enterprise can increase its net MBS outstanding (MBS held by others), they initially limited the growth of each Enterprise’s mortgage asset portfolio to a maximum balance of \$850 billion at the end of 2009. Thereafter, the PSPAs stipulated that the mortgage asset portfolios must shrink by at least 10 percent per year until each

Enterprise's holdings of mortgage assets reached a balance of \$250 billion, at which point, no further reduction would be required by the PSPA.

The PSPAs were amended in September 2008 and in May 2009. The latter amendment, among other things, doubled Treasury's funding commitment to each Enterprise to \$200 billion from \$100 billion, and increased the size of each Enterprise's mortgage asset portfolio allowed under the PSPAs by \$50 billion to \$900 billion. The revised and amended PSPAs left unchanged the requirement that after December 31, 2009, the portfolio holdings of each Enterprise be reduced by at least 10 percent per year from the amount of mortgage assets held at the close of the preceding year until each Enterprise's portfolio holdings of mortgage assets reached a size of \$250 billion.

To further solidify Treasury support for the Enterprises and the role they continue to play in the housing and mortgage markets during the current crisis, the Treasury and FHFA, on December 24, 2009, again amended the PSPAs.¹ That amendment let stand the maximum allowable amount of mortgage assets each Enterprise could own on December 31, 2009—\$900 billion. However, the covenant requiring the Enterprises to reduce their mortgage assets was revised such that it is based on the maximum amount that they were permitted to own as of December 31 of the immediately preceding calendar year, rather than the amounts they actually owned at that time. As revised, beginning on December 31, 2010 and each year thereafter, each Enterprise is required to

¹ Besides amending the provisions relating to the Enterprises' portfolios, the Second Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement (Second Amendment to PSPA) also increased the Treasury's funding commitment to each Enterprise. Specifically, the definition of "maximum amount" was amended to mean "as of any date of determination, the greater of (a) \$200,000,000,000 (two hundred billion dollars), or (b) \$200,000,000,000 plus the cumulative total of Deficiency Amounts determined for calendar quarters in calendar years 2010, 2011, and 2012, less any Surplus Amount determined as of December 31, 2012, and in the case of either (a) or (b), less the aggregate amount of funding under the Commitment prior to such date." Second Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement (Terms and Conditions, para. 3).

reduce its mortgage assets to at most 90 percent of the maximum allowable amount each was permitted to own as of December 31 of the immediately preceding calendar year, until the amount of their respective mortgage assets reaches \$250 billion, at which point, no further reduction is required by the PSPA. As noted in FHFA's February 2, 2010 letter to the leaders of the Senate Banking Committee and the House Financial Services Committee on the status and future of the conservatorship, the amendment to the portfolio limits provides the Enterprises with flexibility to purchase delinquent loans out of guaranteed mortgage-backed securities pools as necessary.

Since the establishment of the conservatorships, the combined losses at the two Enterprises depleted all of their capital and required them to draw \$150.8 billion of senior preferred stock pursuant to the PSPAs through September 2010. By providing a capital backstop to the Enterprises, the Treasury's commitment under the PSPAs effectively eliminated any mandatory triggering of receivership and ensures that the Enterprises have the ability to fulfill their financial obligations and perform their statutory mission without increasing their systemic risk.

D. Interim Final Rule

On January 30, 2009, FHFA published in the **Federal Register** an interim final regulation which added new subchapter C of part 1252 to 12 CFR Chapter XII. See 74 FR 5609. The interim final regulation adopted, by reference, the portfolio holdings criteria established in the PSPAs, as may be amended from time to time. The establishment of criteria governing Enterprise portfolio holdings in the PSPAs in the interim final rule represented an exercise of authority consistent with the authority granted by Congress under section 1369E of the Safety and Soundness Act. FHFA's

goals for the conservatorship include fortifying the capacity of the Enterprises to support the secondary mortgage market. The initial criteria for Enterprise portfolio holdings established in the PSPAs provided the Enterprises with some immediate capacity to provide stability and liquidity to the secondary mortgage market, while mitigating systemic risk, and facilitating Enterprise efforts to achieve a balance between their mission and safe and sound operations in the intermediate term. The February PSPA amendments provided some additional capacity to address market conditions. The December PSPA amendments provided additional flexibility to allow for the purchase of delinquent mortgages. Despite having some additional capacity to grow their retained portfolios since the establishment of the conservatorships, the primary source of Enterprise retained portfolio purchases has been delinquent mortgages. The Enterprises remain on track to be below the \$810 billion retained portfolio limit as of December 31, 2010. The retained portfolio reduction provided for in the PSPAs avoids the need for potentially destabilizing liquidation in the near term, while ensuring that in the future the potential for systemic risk associated with these portfolios is reduced.

The interim final regulation also solicited comments on the overall interim final rule and to a series of questions that relate to portfolio holdings when the Enterprises are no longer subject to their respective PSPAs. Specifically, the interim final rule raised a number of general questions related to the benefits of the Enterprises' purchases and holdings of mortgage assets and the risks, including systemic risk, posed by the mortgage asset holdings, and the mission-related need for the portfolios. The interim final rule also posed specific questions related to the size, composition, and funding of the Enterprises' mortgage asset portfolios.

Finally, the interim final rule solicited comments on a series of general questions related to the Enterprises' holding of non-mortgage assets and well as specific questions on the size and composition of the non-mortgage assets portfolios. While the portfolio holdings criteria set forth in the PSPAs do not address Enterprise holdings of non-mortgage assets, FHFA noted in the interim final regulation the need for the Enterprises to maintain adequate levels of liquidity in order to carry out their day-to-day operating activities. Adequate levels of liquidity strengthen the Enterprises' ability to meet their statutory mission of providing stability and liquidity to the secondary mortgage market, during good times and during periods of market stress, without incurring extraordinary financing costs.

The comment period for the interim final rule closed on June 1, 2009; eight (8) comment letters were received. Those letters are available at the FHFA Web site, <http://www.fhfa.gov/Default.aspx?Page=89&ListNumber=5&ListID=278&ListYear=2009&SortBy=#278>.

II. Discussion of Comments

FHFA requested comments on all aspects of the interim final rule as well as comments on the issues and questions set forth in the preamble concerning criteria governing Enterprise portfolio holdings that will apply when the Enterprises are no longer subject to the PSPAs. In response to that request, FHFA received eight (8) comment letters. Commenters represented trade and special interest groups of various sectors of the housing and mortgage markets. There were no comments from researchers, policymakers, lawmakers, or Enterprise competitors or counterparties.

Two comments included discussion of the interim final regulation. The majority (five) of the public comments included responses to the questions posed regarding Enterprise portfolio holdings when the Enterprises are no longer subject to the PSPAs. Only two (2) commenters touched on Enterprise portfolio holdings while the Enterprises are in conservatorship. One commenter suggested strategies for reengineering the nation's mortgage finance system. In general, commenters were silent on questions regarding the Enterprises' non-mortgage portfolio holdings.

While FHFA considered all comments received, it is important to note that the final rule is based on the fact that the Enterprises are in conservatorship, and that the question of their future status has not yet been resolved.

A. Comments relating to the questions posed in the Interim Final Rulemaking

Several commenters argued that the mortgage asset portfolios of Fannie Mae and Freddie Mac were beneficial because of the limited or lack of access to secondary markets for certain mortgage products. One commenter noted in particular, the absence of a secondary mortgage market for Home Equity Conversion Mortgages and argued that holding those mortgages in portfolio is the only way of providing liquidity to that segment of the mortgage market.

Commenters also responded to FHFA's question concerning the ability of the Enterprises to fulfill their mission without the mortgage portfolios. One commenter stated that the Enterprises, through the 1990s, had fulfilled their mission without portfolios. Some others, however, thought that some portfolio capacity is necessary to provide price stability and liquidity during periods of market stress. A number of

commenters expressed concern about the implication of shrinking the portfolios on, for instance, multifamily and some non-standard loans.

Several commenters argued that the Enterprises' purchase of mortgage assets should vary over the credit cycle or conditions in the secondary markets. One commenter suggested that the portfolios should be viewed as a "safety valve" for providing liquidity when secondary market conditions are adverse or mortgage credit conditions drive away other lending sources.

Relative to the question about the type of mortgage assets the Enterprises should be allowed to hold, one commenter saw little rationale for allowing the Enterprises to hold their own, Ginnie Mae, or private-label mortgage-backed securities (MBS), except during periods of market illiquidity. That commenter suggested that the portfolios should generally be used only to meet mission goals that cannot be met through securitization.

With respect to the question concerning the use of portfolio holdings criteria and the capital regulations and other supervisory tools to address the Enterprises' exposure to additional risk posed by their holdings, one commenter suggested that FHFA establish risk-based capital requirements to cover all portfolio activities. Another commenter suggested that the Enterprises' capital requirements be calibrated in such a manner as to provide incentives for the Enterprises to minimize their portfolio holdings. Still another commenter urged that the Enterprises be held to similar portfolio capitalization standards as commercial banks, noting also that loans held, which have interest rate and credit risk, should be differentiated from loans sold as MBS, which primarily have credit risk for the Enterprises.

Given that the future status of the Enterprises is not yet resolved, FHFA has determined that it is premature to establish criteria or to address the substantive questions raised in the supplementary information to the interim final rule at this stage. There is currently no resolution as to the necessary reforms for the housing finance system or to the question of what form the Enterprises will take if or when they emerge from conservatorship. These issues affect the appropriate regulatory framework. Given these fundamental unresolved issues, the final rule adopts the portfolio limits set forth in the PSPAs. FHFA may revisit the rule when circumstances warrant.

B. Comments relating to the Interim Final Rule

The commenters raised several issues relating to the interim final rule. In one instance, a commenter suggested incorporating the Treasury portfolio limits by restating them in the rule itself, rather than reference the PSPAs. The commenter expressed concern over not knowing how long the PSPAs would remain in effect and over the lack of public notice and comment when the PSPAs are modified or terminated. The commenter noted that the May 2009 amendment to the PSPAs increasing the portfolio limits to \$900 billion for each Enterprise was accomplished without notice and comment. Accordingly, the commenter suggested specifying the portfolio limits in the regulation, which would provide an opportunity for public notice and comment when modifications are made to those portfolio limits, and would ensure that limits remain in place should the PSPAs terminate.

FHFA determined that the proposed change is not necessary or prudent at this time. Section 1369E of the Safety and Soundness Act, as amended by section 1109 of HERA, provides for regulatory portfolio criteria governing the Enterprises as self-

sustaining, privately managed and owned companies, and does not specifically address an Enterprise's portfolio holdings when the Enterprise is in conservatorship. Currently, both Enterprises are in conservatorship and require regular Treasury capital infusions under the PSPAs to remain solvent.

The circumstances of the portfolio regulation are such that it is not reasonable to interpret the Safety and Soundness Act's portfolio provision as requiring notice-and-comment rulemaking in order to change the portfolio limits when the Enterprises are in conservatorship and supported by Treasury infusions of capital. The principal concerns of the statute are safety and soundness, capital adequacy, and limiting systemic risk posed by the Enterprises' retained portfolios. Those concerns are addressed in conservatorship through the vehicles of the PSPAs and FHFA's on-going oversight of the Enterprises' risk management practices. Under the PSPAs, the Treasury provides capital, while enumerated significant business decisions require Treasury approval. While the Enterprises are operating under conservatorship, FHFA maintains continual oversight of the risk management practices associated with the Enterprises' retained portfolios, even more directly than it does in its capacity as regulator. In terms of systemic risk, the PSPAs prescribe an orderly reduction in the portfolios, reducing risk to the Enterprises while at the same time providing market stability by not requiring a too-rapid sell-off of portfolio assets. In addition, allowing room within the portfolio limits for repurchases of delinquent mortgages from outstanding MBS is necessary for loan modifications, which also contribute to overall market stability. Balancing these competing needs in a time of market stress such as the present requires greater flexibility in portfolio management than notice-and-comment rulemaking permits, and therefore in these circumstances, when the

Enterprises are in conservatorship, we do not interpret the statute as requiring it.

Accordingly, the final regulation retains the language from the interim final regulation.

Another commenter suggested that, pursuant to HERA, FHFA establish a formal process of reviewing the Enterprises' portfolio holdings and a mechanism for adjusting the portfolio limits based on such reviews. Such a process would allow formal periodic adjustment of the portfolio parameters in response to conditions in the market. Related to the process of adjusting the portfolio parameters, a third commenter expressed concern over the 10 percent reduction in the Enterprise portfolios after December 31, 2009. This commenter asks for greater flexibility during times of crisis. FHFA monitors the Enterprises' portfolios through supervisory and conservatorship channels. If market conditions dictate a need to consider the portfolio reduction provisions in the PSPAs, FHFA will take the appropriate actions to seek amendments to the PSPAs. FHFA thus concludes no change to the interim final rule in this regard is necessary at this time.

III. Final Rule

FHFA adopts the portfolio holdings criteria established by the PSPAs, as may be amended from time to time, as the standard governing the holding of mortgage assets by the Enterprises. Under the PSPAs, which currently have the same portfolio holdings criteria for both Enterprises, beginning on December 31, 2010, and each year thereafter, each Enterprise is required to reduce its mortgage assets to 90 percent of the maximum allowable amount it was permitted to hold as of December 31 of the immediately preceding calendar year, until the maximum amount of the mortgage assets owned by each Enterprise reaches \$250 billion. Thus, the maximum allowable amount of mortgage assets that each Enterprise may own as of December 31, 2010, is \$810 billion.

This regulation will remain in effect until amended or the Enterprises are no longer subject to the PSPAs. Amendments to the portfolio limits and criteria on the limits can be made by amendment of the PSPAs. Under the final regulation, the Enterprises are to comply with the PSPA portfolio limits as amended from time to time.

While the final regulatory criteria incorporate the PSPAs' portfolio limits as agreed upon by the Treasury and FHFA as conservator, the Safety and Soundness Act provides that the Director monitor the portfolio of each Enterprise and authorizes the Director to order an Enterprise to dispose of or acquire any asset under terms and conditions to be determined by the Director, if the Director determines that such action is consistent with the purposes of the Safety and Soundness Act or the authorizing statute of the Enterprise. 12 U.S.C. 4624(c).

IV. Section by Section Analysis

Section 1252.1

Section 1252.1 adopts the portfolio holdings criteria established by the PSPAs, as they may be amended from time to time, as the standard for this rule.

Under the current PSPAs, which have the same portfolio holdings criteria for both Enterprises, an Enterprise may hold mortgage assets up to \$900 billion as of December 31, 2009. Starting on December 31, 2010, the Enterprise portfolio limits will decrease annually by 10 percent from the maximum limit in the preceding year until the limit reaches a level of \$250 billion, at which point, no further decrease is currently required. Adjustments could be made to those criteria by amendment of the PSPAs.

Compliance with the PSPAs is necessary to ensure that each Enterprise receives adequate capital to support its ongoing business operations. FHFA's goals for the

conservatorship include strengthening Enterprise capacity to support the secondary mortgage market. The criteria for Enterprise portfolio holdings established in the PSPAs provided the Enterprises capacity to provide stability and liquidity to the secondary mortgage market (including the purchase of delinquent mortgages), while mitigating systemic risk, and facilitating Enterprise efforts to achieve a balance between their mission and safe and sound operations in the intermediate term. The retained portfolio reduction provided for in the PSPAs avoids the need for potentially destabilizing liquidation in the near term, while ensuring that in the future the potential for systemic risk associated with these portfolios is reduced.

FHFA's establishment of PSPA portfolio criteria as its regulatory criteria represents an exercise of authority consistent with the authority granted by Congress under section 1369E of the Safety and Soundness Act.

Section 1252.2

Section 1252.2 addresses the effective duration of the interim rule. FHFA expects these regulations to be effective until any amendment or until the Enterprises are no longer subject to the terms and obligations of the PSPAs.

V. Paperwork Reduction Act

The regulation does not contain any collections of information pursuant to the Paperwork reduction Act of 1995 (44 U.S.C. 3501 et seq.). Therefore, FHFA has not submitted any information to the Office of Management and Budget for review.

VI. Regulatory Flexibility Act

The regulation applies only to the Enterprises, which do not come within the meaning of small entities as defined in the Regulatory Flexibility Act (RFA). See 5

U.S.C. 601(6). Therefore, in accordance with section 605(b) of the RFA, 5 U.S.C. 605(b), FHFA, hereby, certifies that the regulation will not have a significant economic impact on a substantial number of small entities.

List of Subjects:

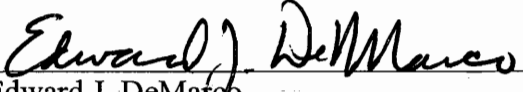
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Government-sponsored enterprises, Mortgages, Portfolio holdings.

PART 1252—PORTFOLIO HOLDINGS

Authority and Issuance

Therefore, the Federal Housing Finance Agency hereby adopts the interim final rule, published at 75 FR 5609 (January 30, 2009) as final without change.


Edward J. DeMarco,
Acting Director, Federal Housing Finance Agency.

12/17/2010
Date