FACT SHEET: PROPOSED RULE TO AMEND THE ENTERPRISE REGULATORY CAPITAL FRAMEWORK

FHFA Proposed Rule to Amend The Enterprise Regulatory Capital Framework

BACKGROUND

The Housing and Economic Recovery Act of 2008 amended the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 to require the Federal Housing Finance Agency (FHFA) to establish, by regulation, risk-based capital requirements for Fannie Mae and Freddie Mac (the Enterprises) to ensure that each Enterprise operates in a safe and sound manner, maintaining sufficient capital and reserves to support the risks that arise in the operations and management of the Enterprises.

On December 17, 2020, FHFA published a final rule to establish the Enterprise Regulatory Capital Framework (ERCF). FHFA subsequently published three amendments in 2022.

FHFA is seeking comments on a notice of proposed rulemaking (NPR, or proposed rule) that would further amend the ERCF. By enhancing, clarifying, and otherwise refining various regulatory capital requirements for the Enterprises, the NPR would improve the safety and soundness of the Enterprises and contribute to the furtherance of the Enterprises' missions.

SUMMARY

The proposed rule includes twelve areas of refinement to the current capital rule. Key changes include:

- A 5 percent risk weight and 50 percent credit conversion factor for cross guarantees on commingled securities;
- A risk multiplier of 0.6 for multifamily mortgage exposures associated with properties with certain government subsidies;
- A standardized approach for counterparty credit risk (SA-CCR) as the method for computing risk weights for derivatives and cleared transactions;
- A modified procedure for determining a representative credit score for single-family mortgage exposures.

The NPR also refines provisions related to credit scores, guarantee assets, mortgage servicing assets, time-based calls for CRT exposures, interest-only MBS, the single-family countercyclical adjustment, the stability capital buffer, and the compliance date for the advanced approaches.

SUMMARY OF THE PROPOSED RULE

Guarantees on Commingled Securities

A commingled security is a certain resecuritization where the underlying collateral includes both securities that are issued and guaranteed by Fannie Mae and securities that are issued and guaranteed by Freddie Mac. The ERCF includes risk-based, leverage, and buffer capital requirements for guarantees on commingled securities. To better align the capital requirements with the counterparty risk inherent in cross guarantees, the NPR would reduce the risk weight from 20 percent to 5 percent and the credit conversion factor from 100 percent to 50 percent on an Enterprise's exposure to the other Enterprise in commingled securities.

These proposed changes would build on FHFA's 2019 final rule on the Uniform Mortgage-Backed Security (UMBS), which aimed to enhance liquidity in the MBS marketplace and foster the efficiency and liquidity of the secondary mortgage market. The UMBS are a single-class security issued by either Fannie Mae or Freddie Mac backed by single-family mortgage loans purchased by the issuing Enterprise. For the UMBS market to operate successfully, market participants generally must agree that a UMBS of a certain coupon, maturity, and loan origination year issued by one Enterprise is roughly equivalent to the corresponding UMBS issued by the other Enterprise.

To foster this fungibility, each Enterprise may issue "Supers," which are single-class resecuritizations of UMBS, or other types of structured securities in which the collateral can include UMBS, such as collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs). If an Enterprise guarantees a security backed in whole

or in part by securities of the other Enterprise, the Enterprise is obligated under its guarantee to fund any shortfall in the event that the other Enterprise fails to make a payment due on its securities. Therefore, investors in commingled securities benefit from the original guarantees extended by guarantors of the underlying collateral, as well as the additional guarantees of the resecuritizing Enterprise, including on the commingled collateral.

The proposed change to the risk weight for guarantees on commingled securities would further foster fungibility by reducing an Enterprise's incentive to only guarantee Supers securities collateralized by its own UMBS – a practice that could lead to different volumes and investor perceptions of UMBS issued by each Enterprise, and potentially to a bifurcation of UMBS pricing and trading. In addition, the proposed change to the credit conversion factor for guarantees on commingled securities would enhance the liquidity of UMBS and the overall stability of the secondary mortgage market by reducing the leverage and buffer capital impact of these guarantees.

FHFA estimates that under the proposed rule, the total common equity tier 1 capital (CET1) required to meet the risk-based capital requirements and buffers for the Enterprises' guarantees on commingled securities as of June 30, 2022 would decline by approximately $5.1 billion.

Multifamily Government Subsidy Risk Multiplier

Properties with government subsidies represent an important segment of the Enterprises' multifamily business models. Each year, FHFA directs the Enterprises to meet specific affordable housing or mission goals by acquiring multifamily loans collateralized by properties that charge rents affordable to certain segments of the population with specified income levels. Strong demand for these affordable rental units and incentives for property owners to follow contractual restrictions in order to retain the subsidies suggest that loans collateralized by government-subsidized properties are less risky than loans collateralized by unsubsidized properties, all else equal. To reflect this difference in risk, the proposed rule would introduce a risk multiplier of 0.6 (i.e., a 40 percent reduction) for multifamily mortgage exposures collateralized by properties with certain government subsidies, subject to certain affordability criteria.

Government subsidies of affordable housing are issued either at the federal or state and local levels, typically in the form of a tax credit, direct subsidy, or voucher reimbursement. Many subsidies last for multiple years and remain in place only if the property owner meets certain program-specific requirements. Further, many government subsidy programs require property owners to make a specified percentage of units affordable to residents at or below a certain percent of area median income. Because government subsidies vary across many dimensions, FHFA sought to capture only government subsidies are that are significant, long-term, and continuous. The NPR would achieve this by imposing limitations on included subsidy programs and through affordability criteria. The applicable government subsidy programs would be limited to: (i) Low-Income Housing Tax Credit (LIHTC), (ii) Section 8 project-based rental assistance, and (iii) state and local affordable housing programs that require the provision of affordable housing for the life of the loan. In addition, a multifamily mortgage exposure would only qualify for the 0.6 risk multiplier if the Enterprise can verify that each property serving as collateral has at least 20 percent of its units restricted as affordable units, where the affordability restriction means less than or equal to 80 percent of AMI.

FHFA estimates that under the proposed rule, required CET1 capital for the Enterprises' multifamily mortgage exposures as of June 30, 2022 would decline by approximately $0.4 billion.

Derivatives and Cleared Transactions

The ERCF requires the Enterprises to hold risk-based capital against derivative exposures to reflect the risk that a

counterparty may default on its obligations and fail to pay the amount owed under the derivative contract. Today, the Enterprises use the current exposure methodology (CEM) to determine an exposure amount for each derivative contract. However, CEM was developed prior to the financial crisis and has several drawbacks, including a lack of differentiation between margined and unmargined derivative contracts, an inadequate recognition of the risk-reducing benefits of a balanced derivatives portfolio, and outdated supervisory conversion factors. To reflect recent market innovations and advances in regulatory requirements, the Basel Committee on Banking Supervision (Basel Committee) developed the standardized approach for counterparty credit risk (SA-CCR) and published it as a final standard in 2014. The U.S. banking regulators adopted SA-CCR as a replacement for CEM in 2020. The proposed rule would require the Enterprises to use SA-CCR rather than CEM to calculate exposure amounts for over-the-counter and cleared derivative contracts, as well as to calculate risk-weighted asset amounts for default fund contributions.

SA-CCR is a risk-sensitive, standardized, non-modelled approach to calculating replacement costs and potential future exposures for derivative contracts. Compared to CEM, SA-CCR improves collateral recognition by differentiating between margined and unmargined derivative contracts, and better captures recently observed stress volatilities among the primary risk drivers for derivative contracts. Through the implementation of SA-CCR, the proposed rule would allow an Enterprise to recognize the meaningful, risk-reducing relationship between derivative contracts within a balanced derivatives portfolio and to recognize the risk-mitigation effects of guarantees, credit derivatives, and collateral when determining risk-based capital. In addition, the proposed rule would result in better alignment between the ERCF, the U.S. banking framework, and the international standards issued by the Basel Committee.

FHFA estimates that under the proposed rule, the total CET1 capital required to meet the risk-based capital requirements and buffers for the Enterprises' derivatives and cleared transactions as of September 30, 2022 would increase by less than $0.1 billion.

Representative Credit Score for Single-family Mortgage Exposures

Credit scores play an important role in the ERCF calculation of risk weights for single-family mortgage exposures due to their strong correlation with the likelihood of borrower default. Borrowers often have credit scores from more than one national consumer reporting agency (repository) and a mortgage can have multiple borrowers, so each single-family mortgage exposure is normally associated with multiple credit scores. To account for these multiple credit scores, the ERCF includes a procedure to determine a single representative credit score for each single-family mortgage exposure. The proposed rule would modify the current procedure for selecting a representative credit score to reflect FHFA's announcement in October 2022 that the Enterprises will require two, rather than three, credit reports from the repositories (bi-merge credit report requirement).

Today, the Enterprises employ a two-step procedure for identifying the representative credit score on a single-family mortgage exposure. In the first step, an Enterprise selects a single score for each borrower on the loan by either selecting the median score if the borrower has scores from three repositories or selecting the lowest score if the borrower has fewer than three scores. In the second step, an Enterprise determines the representative score for the exposure by selecting the lowest single score across all borrowers from step one. After the adoption of the bi-merge credit score requirement, the current procedure for determining a representative credit score could result in a significant downward shift in representative credit scores for most borrowers. To mitigate this risk, the proposed rule would modify step one by requiring an Enterprise to calculate the average credit score across repositories for each borrower rather than choosing the median score. This change should lessen concerns about downward bias in the representative credit score distribution, as the average across the two scores is closer to the center of the borrower's credit score distribution than the minimum

across scores. The proposed change would also alleviate concerns about when the bi-merge credit score requirement will be implemented, because FHFA's analysis showed little difference between representative credit score distributions created using the average approach compared to using the median approach when three scores are available.

FHFA estimates that under the proposed rule, the total CET1 capital required to meet the risk-based capital requirements for the Enterprises' single-family mortgage exposures as of June 30, 2022 would decline by less than $0.1 billion.

Other Changes

The proposed rule would make a number of additional modifications to the ERCF that would enhance, clarify, or otherwise refine the capital requirements for the Enterprises. Specifically, the proposed rule would:

- Require the Enterprises to assign an original credit score of 680 to single-family mortgage exposures without a permissible credit score at origination, rather than 600;
- Introduce a 20 percent risk weight for guarantee assets;
- Expand the definition of mortgage servicing assets to include servicing rights on mortgage loans owned by anyone, including the Enterprise;
- Delay the first application of the single-family countercyclical adjustment on new originations to coincide with the first update to the property values associated with those single-family mortgage exposures;
- Explicitly permit eligible time-based call options in the credit risk transfer (CRT) operational criteria;
- Amend the risk weights for interest-only (IO) mortgage-backed securities (MBS) to 0 percent, 20 percent, and 100 percent, conditional on whether the security was issued by the Enterprise, the other Enterprise, or a non-Enterprise entity, respectively;
- Clarify the calculation of the stability capital buffer when an increase and a decrease might be applied concurrently; and
- Extend the compliance date for the advanced approaches to January 1, 2028.

FHFA estimates that under the proposed rule, the total CET1 capital required to meet the Enterprises' risk-based capital requirements as of June 30, 2022 would decline by approximately $0.2 billion due to the eight other changes listed above.

Overall, FHFA estimates that under the proposed rule, the total CET1 required to meet the Enterprises' risk-based capital requirements and buffers as of June 30, 2022 would decline modestly from approximately $226.4 billion to approximately $220.8 billion. Similarly, total required adjusted total capital would decline from approximately $302.4 billion to $294.2 billion.