FINANCIAL STABILITY OVERSIGHT COUNCIL STATEMENT ON ACTIVITIES-BASED REVIEW OF SECONDARY MORTGAGE MARKET ACTIVITIES

The Council has conducted a review of the secondary mortgage market, which is an integral component of the U.S. housing finance system. Financial stress in the secondary mortgage market has the potential to affect the availability and terms of mortgage credit, and to affect the economy more broadly. The Council's review focused in particular on the activities of Fannie Mae and Freddie Mac (the Enterprises) as the dominant private secondary market providers of liquidity through their purchase of mortgages for securitization and sale as guaranteed MBS.

In assessing potential risks to financial stability, the Council applied the framework for an activities-based approach described in the interpretive guidance on nonbank financial company determinations issued by the Council in December 2019. This framework provides that the Council will consult with relevant financial regulatory agencies, consider the risk profiles and business models of market participants engaging in the activities under evaluation, and take into account existing laws and regulations that may mitigate a potential risk to U.S. financial stability.

The Council's analysis considered: (1) how a potential risk to financial stability could be triggered from the Enterprises' inability to provide secondary market liquidity; (2) how those stresses could be transmitted to financial markets or other market participants; (3) the impact on the financial system of the Enterprises' inability to continue to provide secondary market liquidity; and, (4) the extent to which the financial system could be impaired in a manner that could harm the non-financial sector of the U.S. economy.

The 2008 financial crisis demonstrated that financial stress at the Enterprises could limit their ability to provide reliable liquidity to the secondary market or perform their guarantee and other obligations on their MBS and other liabilities, with significant implications for the national housing finance markets, financial stability, and the broader economy. The Enterprises continue to play a central role in the national housing finance markets—acquiring nearly 50% of newly originated mortgages in both single-family and multifamily markets—and are two of the largest U.S. financial institutions. The Enterprises' provision of secondary market liquidity generates significant interconnectedness among the Enterprises, banks, non-bank financial institutions, and other counterparties. Moreover, given their similar business models, risks at the Enterprises are highly correlated; if one Enterprise experiences financial distress, the other may as well. If the Enterprises were unable to provide liquidity to the secondary market, other market participants may be unable in the near- or medium-term to provide liquidity at the scale and pricing needed to ensure smooth market functioning and financial intermediation. As a result, any distress at the Enterprises that affected their secondary mortgage market activities, including their ability to perform their guarantee and other obligations on their MBS and other liabilities, could pose a risk to financial stability, if risks are not properly mitigated.

FHFA has the responsibility to ensure that each Enterprise operates in a safe and sound manner and fosters liquid, efficient, competitive, and resilient national housing finance markets, and the authority to set and enforce appropriate rules to fulfill that responsibility. In preparation for the Enterprises' exit from conservatorship, FHFA has been developing a more robust prudential regulatory framework for the Enterprises, including capital, liquidity, and stress testing requirements, supervision, and a credible resolution framework, to, among other things, address the risk that an Enterprise's default or other financial distress could have on the national housing finance markets. FHFA recently proposed a new capital regulation ("Enterprise Regulatory Capital Framework," June 30, 2020) that is intended to enhance the quality and quantity of required capital so as to ensure that each Enterprise is capitalized to remain a viable going concern both during and after a severe economic downturn and also to mitigate the potential risk to national housing finance markets posed by the Enterprise. The proposed Enterprise capital rule represents a significant step by FHFA to address the Council's recommendation in its 2019 Annual Report that FHFA continue to develop capital and other prudential requirements for the Enterprises.

Capital is a core component of the regulatory framework because capital absorbs unexpected losses and helps promote market discipline by aligning incentives and curtailing excessive risk-taking. Moreover, significant private capital is the foundation for resilient national housing finance markets. As such, much of the Council's analysis of the extent to which FHFA's regulatory framework would adequately mitigate potential stability risks centered on FHFA's recent capital proposal.

In conducting its review, the Council considered the following two questions, among others:

(1) Is the proposed capital rule appropriately sized and structured given the Enterprises' risks and their key role in the housing finance system?
(2) Does the proposed capital rule promote stability in the broader housing finance system?

Based on its assessment of the proposed rule, the Council's key findings are as follows:

Risk-Based Capital Requirements: The proposed rule includes a risk-sensitive capital framework that would result in a granular calibration of credit risk capital requirements. The alignment of market participants' credit risk capital requirements across similar credit risk exposures would mitigate risk to financial stability by minimizing market structure distortions. The Council evaluated whether the proposed rule generally would align credit risk capital charges with those of other market participants.

The proposed rule would require aggregate credit risk capital on mortgage exposures that, as of September 2019, would lead to a substantially lower risk-based capital requirement than the bank capital framework. Given that the proposed rule's risk weights are highly sensitive to certain risk characteristics of the exposures, average risk weights and the required credit risk capital would change through the credit cycle. The Enterprises' credit risk requirements, however, likely would be lower than other credit providers across significant portions of the risk spectrum and during much of the credit cycle, which would create an advantage that could maintain significant concentration of risk with the Enterprises.

The Council encourages FHFA and other regulatory agencies to coordinate and take other appropriate action to avoid market distortions that could increase risks to financial stability by generally taking consistent approaches to the capital requirements and other regulation of similar risks across market participants, consistent with the business models and missions of their regulated entities.

Capital Buffers: The proposed rule includes a stress capital buffer and a stability capital buffer that would require the Enterprises to hold capital above their regulatory requirements. A stress capital buffer would mitigate risks to financial stability by requiring the Enterprises to hold sufficient capital to withstand a severely adverse stress and still remain viable going concerns. A stability capital buffer would mitigate risks to financial stability by reducing the expected impact of an Enterprise's distress on financial markets or other financial market participants and by addressing the potential for decreased market discipline due to an Enterprise's size and importance. The stress capital buffer would be set at 0.75% of an Enterprise's adjusted total assets. The stability capital buffer, which would also be calibrated based on adjusted total assets, would vary according to an Enterprise's share of total mortgage debt outstanding. The Council evaluated whether the proposed capital buffers were appropriately structured to address the risks posed to financial stability by the Enterprises' activities.

The inclusion of such capital buffers is an important step to mitigating the risks the Enterprises pose to the broader system. The calibration of the buffers in the proposed rule might help achieve certain policy goals, such as reducing the buffers' impact on higher risk exposures, but it might be relatively risk-insensitive. Because the proposed buffers change based on adjusted total asset size and market share, an Enterprise's capital buffers could decline on a risk-adjusted basis in response to deteriorating Enterprise asset quality or during periods of stress. Although a more risk-sensitive approach to calibrating the buffers could increase the pro-cyclicality of the aggregate risk-based capital requirements, it also might be better tailored to each Enterprise's risks to financial stability and also allow them to better serve their function of providing an additional source of capital that can absorb losses during periods of severe stress.

The Council encourages FHFA to consider the relative merits of alternative approaches for more dynamically calibrating the capital buffers. The capital buffers should be tailored to mitigate the potential risks to financial stability and otherwise ensure that the Enterprises have sufficient capital to absorb losses during periods of severe stress and remain viable going concerns, while balancing other policy objectives.

Total Capital Sufficiency: The proposed rule would increase the quality and quantity of capital that the Enterprises would be required to hold. Significant high-quality capital would mitigate risks to financial stability by making it more likely that the Enterprises will be able to perform their countercyclical function and maintain market confidence as viable going concerns through the economic cycle. Similarly, a meaningful leverage ratio requirement that is a credible backstop to the risk-based requirements would address potential risks to financial stability by ensuring that the capital requirements are consistent with historical loss experiences during severe stresses while mitigating model, measurement, and related risks with a simple, transparent measure of risk. The Council assessed whether the Enterprises would be required to hold capital of sufficient quality and quantity to allow them to remain viable as going concerns after a severe economic downturn.

The proposed rule, by relying on definitions of regulatory capital that are similar to that of the U.S. banking framework, would ensure that high-quality capital is the predominant form of regulatory capital. The use of well-understood definitions of regulatory capital also fosters market discipline over each Enterprise's risk-taking by facilitating the ability of shareholders, creditors, and other counterparties to understand the Enterprise's capital position.

With respect to the quantity of regulatory capital, the Council considered the proposed capital requirements in light of a number of relevant benchmarks, such as: (1) losses during the 2008 financial crisis; (2) a comparison of the proposed capital requirements to those of other large, complex financial institutions, taking into account differences in business models and risk profiles; and (3) the capital requirements implied by a conservative mortgage stress test model.

The proposed rule requires a meaningful amount of capital for the Enterprises, and is a significant step towards ensuring that the Enterprises would be able to provide liquidity to the secondary mortgage market and satisfy their obligations during and after a period of severe stress. However, the Council's analysis using benchmark comparisons suggests that risk-based capital requirements and leverage ratio requirements that are materially less than those contemplated by the proposed rule would likely not adequately mitigate the potential stability risk posed by the Enterprises. Moreover, it is possible that additional capital could be required for the Enterprises to remain viable concerns in the event of a severely adverse stress, particularly if the Enterprises' asset quality were ever to deteriorate to levels comparable to the experience leading up to the 2008 financial crisis.

The Council encourages FHFA to ensure high-quality capital by implementing regulatory capital definitions that are similar to those in the U.S. banking framework. The Council also encourages FHFA to require the Enterprises to be sufficiently capitalized to remain viable as going concerns during and after a severe economic downturn.

In addition to a capital framework, FHFA is also implementing significant additional enhancements to the Enterprises' regulatory framework that would help mitigate the potential risk to financial stability, thereby enabling the Enterprises to provide secondary market liquidity throughout the economic cycle. These enhancements include efforts to strengthen Enterprise liquidity regulation, stress testing, supervision, and resolution planning. The Council supports FHFA's commitment to developing its broader prudential regulatory framework for the Enterprises and encourages FHFA to continue those efforts.

Should these reforms be implemented appropriately, they will lead to a more durable secondary mortgage market that helps provide sustainable access to mortgage credit across the economic cycle and is more resistant to shocks that could impair financial intermediation or financial market functioning to a degree that would be sufficient to inflict significant damage on the broader economy. The Council will continue to monitor the secondary mortgage market activities of the Enterprises and FHFA's implementation of the regulatory framework to ensure potential risks to financial stability are adequately addressed; if the Council determines that such risks to financial stability are not adequately addressed by FHFA's capital and other regulatory requirements or other risk mitigants, the Council may consider more formal recommendations or other actions, consistent with the December 2019 guidance.