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FHFA finalizes amendments to Enterprise Regulatory Capital Framework for commingled securities, mortgage exposures, and derivatives and cleared transactions

Center *for* **Regulatory Strategy US**

Initial perspectives related to the amendments to the Enterprise Regulatory Capital Framework (ERCF) and key changes

On November 21, 2023, the Federal Housing Finance Agency (FHFA) finalized a rule on the Enterprise Regulatory Capital Framework (ERCF) which modifies various regulatory capital requirements for the **Federal National Mortgage Association (Fannie Mae)** and the **Federal Home Loan Mortgage Corporation (Freddie Mac)** (each an "Enterprise").[1] The rule adopts many of the aspects of the March 2023 proposal, including guarantees on commingled securities, multifamily mortgage exposures, and credit scores for single-family mortgages. The effective date for the amendments is April 1, 2024, while the effective date for some aspects, including the standardized approach for counterparty credit risk (SA-CCR), is January 1, 2026.

5 insights you should know

Risk weights and credit conversion factor (CCF) for commingled securities: The Final Rule significantly reduces the risk weight under the standardized approach for guarantees on commingled securities from 20% to 5% and lowers the CCF for guarantees on commingled securities from 100% to 50%. The risk weight in the Final Rule aligns with the risk-weight floor for retained credit risk transfer (CRT) exposures, while the CCF aligns with capital treatment for certain undrawn off-balance sheet commitments.

Multifamily government subsidy risk multiplier: The Final Rule introduces a risk multiplier under the standardized approach scaled between 0.6 and 1.0 for multifamily mortgage exposures secured by at least one applicable government subsidy, subject to certain affordability criteria. The current rule does not differentiate between multifamily mortgage exposures secured by properties with a government subsidy and those without. The introduction of a risk multiplier is intended to reflect the lower credit risk associated with multifamily mortgage exposures secured by properties with a significant, long-term, and continuous government subsidy.

Derivatives and cleared transactions: The Final Rule replaces the current exposure methodology (CEM) with SA-CCR for calculating risk-weighted assets related to over-the-counter (OTC) derivative contracts, cleared derivative contracts, and default fund contributions. Relative to CEM, SA-CCR provides important improvements to risk sensitivity and calibration, including by differentiating between margined and unmargined derivative contracts and recognizing the benefits of netting agreements. The Final Rule also adopts the requirement to add credit valuation adjustment (CVA) risk-weighted assets to the calculation of standardized total risk-weighted assets.

Original credit scores for single-family mortgage exposures: The current regulation assigns a default credit score of 600 to single-family mortgage exposures with unscored borrowers, placing them in the lowest ERCF credit score buckets, indicating the highest perceived risk. The Final Rule replaces this and requires Enterprises to assign an original credit score of 680 under the standardized approach, subject to Enterprise verification that none of the borrowers have a credit score at one of the repositories.

Representative credit scores for single-family mortgage exposures: The FHFA declined to adopt a proposed change to the procedure for selecting a representative credit score for single-family mortgages when multiple credit scores have been submitted for at least one borrower. The proposal would have required an Enterprise to use an average credit score for each borrower whenever multiple scores are present as opposed to the current methodology which requires an Enterprise to select the median borrower credit score when three scores are present or the lower borrower credit score when two scores are present.

5 considerations to evaluate

1. **Reduced capital requirements to enhance liquidity for UMBS:** The reductions in risk weights and credit conversion factors are intended to more accurately reflect the counterparty risks posed by commingling activities, improve the liquidity of the Enterprises' securities, and strengthen the housing finance market. As a result, market participants should see improved liquidity in the secondary mortgage market and more fungibility between the collateral issued by the Enterprises that back uniform mortgage-backed securities (UMBS).

2. **New risk multiplier supports financing of affordability housing market:** The new multiplier is intended to better align with the Enterprises' affordable housing goals by freeing up capital and incentivizing the Enterprises to expand their financing of affordable housing. Consequently, mortgage originators may see greater appetite from the Enterprises to purchase affordable, multifamily housing mortgages, while investors may experience lower mortgage rates.

3. **SA-CCR to align Enterprises with banking framework:** The introduction of SA-CCR is designed to align the ERCF to the U.S. banking advanced approach framework and limit certain capital arbitrage opportunities between Enterprises, and between the Enterprises and large banking organizations. Due to the level of complexity involved, the Enterprises will have a 24-month implementation period to come into compliance, at which point, the housing finance sector should have greater consistency in the calculation of counterparty credit risk.

4. **Increased default credit score supports unscored borrower mortgages:** The increase in the original credit score for unscored single-family mortgage exposures from 600 to 680 is intended to reflect post-crisis improvements in regulatory, underwriting, and lending standards, as well as the recent inclusion of positive rental payment histories in the Enterprises' automated underwriting systems. By lowering the default risk assessment of unscored borrowers, the rule should increase mortgage access to borrowers without credit scores and increase Enterprise financing of such mortgages.

5. **FHFA may still implement credit score averaging:** The FHFA determined not to adopt the proposed change to representative credit scores at this time given the ongoing public engagement on the planned transition for Enterprises to use two, rather than three, credit reports.[2] The FHFA noted they may finalize this aspect of the proposal in the future—potentially without another notice and comment period. Therefore, mortgage originators should remain attentive to the FHFA's actions and conduct periodic analysis for how averaging of credit scores will likely impact their portfolio risk assessment.

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[1] FHFA, "Enterprise Regulatory Capital Framework – Commingled Securities, Multifamily Government Subsidy, Derivatives, and Other Enhancements," November 21, 2023.
[2] FHFA, "FHFA Announces Public Engagement Process for Implementation of Updated Credit Score Requirements," March 23, 2023.

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