GSE Activity Report

Monday, May 9, 2016

Going Short on Lending Long

Summary

The latest really big deal in big-bank regulation is the inter-agency proposal approved last week by the Federal Reserve to introduce the global net stable funding ratio (NSFR) in the U.S. The NSFR is tied to the already-final liquidity coverage ratio (LCR) to require big banks to hold enough stable funds over a year to prevent not just short-term liquidity freezes like the ones that toppled finance in 2008, but also longer-term funding mismatches that could so weaken a big bank that it dies a slow, costly death. Like the LCR, the NSFR will have significant implications not only on how big banks choose to fund themselves, but also on the assets they hold and the terms on which these are offered. The U.S. rule will, like Basel's, have significant adverse implications for repos, including those involving the GSEs, continuing the long slide in big-bank repo activity with potentially significant and adverse impact on overall market liquidity. Like earlier global and U.S. liquidity rules, the NSFR also takes a dim view of securitization and mortgage-risk positions (including RMBS), adding now a similarly cautious view of long-term mortgages when these are housed on bank portfolios. Home-equity liens do, though, catch a break if they can be characterized as unconditionally cancellable.

Impact

When the agencies released the NSFR notice of proposed rulemaking (NPR), they emphasized that the big-bank shortfall was a negligible $39 billion. Big banks beg very much to differ not so much because the shortfall is off, but because it's calculated under current, ultra-low rates that do not reflect the large, upward changes in liabilities likely once rates start to rise. At that point, significant changes in big-bank repo, mortgage, and clearing operations will ensue if the NSFR is finalized as proposed.

Points key to understanding the NSFR's impact include:

- The NSFR measures liquidity over one-year, extending beyond the 30-day LCR horizon in part because regulators fear that, without an NSFR, banks will simply push their liquidity risk out to 31 days. Like the LCR, banks can fall below the NSFR but only rarely and in concert with fast notice to regulators and

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immediate action on a remediation plan that, in our view, will be gentle if the shortfall results from systemic, not idiosyncratic, liquidity stress.

- The numerator in the NSFR is available stable funding (ASF), with different types of funding given liquidity-risk weights based on stability expectations, and required stable funding (RSF), which is based on weightings derived from regulatory expectations about how likely an asset is to require funding over the course of a year. Securitization is considered a poor source of ASF, meaning that expectations of originate to distribute are thoroughly discounted unless or until the asset departs the bank's books.
- High-quality liquid assets (HQLAs) and assets like cash and FRB reserves have low RSFs, meaning that holding them does not cost the bank on the ASF side. Thus, although the LCR and NSFR function differently, their net effect is the same: covered banks will be under strong incentives to hold lots of HQLAs, leaving less capital capacity for productive assets, including on-balance sheet mortgages and any line of credit that does not meet the criteria for "unconditional cancellability." HQLAs are defined in the LCR, meaning that sovereigns are given the most favorable treatment followed by limited recognition of agency paper and FHLB advances. PLS count for naught as HQLAs and, under the NPR, are in fact considered costly assets for RSF purposes.
- ASFs must be on hand for assets the bank plans to book over the course of the year even if it has full flexibility to cease originating loans (e.g., mortgages) during the year. As a result, a year's worth of mortgage origination has to be backed by a year's worth of ASF at the 65% or 85% RSF levels applicable to booked loans even though the bank might end up holding the costly liabilities for at least a quarter or two if it changed its mortgage plans and did not originate the loans.
- BHCs are even less likely than before to acquire non-bank mortgage servicing or origination operations, especially if these cannot quickly be assimilated into the banking subsidiaries. The NSFR, like the LCR, takes a dim view of non-bank subsidiaries and forces BHCs to "trap" costly liquidity within them.
- Like the global NSFR, the U.S. proposal provides fewer advances for clearing through central counterparties (CCPs) than global banks initially anticipated. This will increase the cost of CCP clearing which, although CCP transactions will get better margin treatment, may lead large banks to curtail derivative-clearing operations where they can and/or impose these higher costs on their counterparties. Given the GSEs' role in the swaps market, these costs are likely to land most heavily and immediately on them.
- The NSFR will hit not just hard, but also fast given the very short transition period contemplated in the NPR. Smaller BHCs (i.e., those with assets between $50 billion and $250 billion) do, however, get a "modified" NSFR that will go a bit easier on them. .

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What else is significant for mortgage finance in the U.S. NSFR proposal?

- The most favored mortgage assets are those that are eligible for a 50% risk weighting – i.e., those with LTVs below 80 or with MI. We expect the NSFR to combine with the overall risk-based capital (RBC) and leverage capital rules to create strong incentives for large banks to hold mortgages that meet the 50% weighting – i.e., low-LTV or non-conforming/non-QM jumbo loans or even HLTV loans with or without MI. However, the ASF requirement (65%) is much higher than banks generally think warranted for long-term mortgages that do not mature within one year, increasing incentives for securitization despite the adverse ASFs if securitization is assured through Ginnie or the GSEs.
- Mortgages without MI receive an 85% RSF, which each bank will need to consider to assess whether or not the cost of MI is worth it for retaining HLTV loans on their books.
- Because of the way the risk weightings work into the NSFR, the proposal also increases incentives for piggyback mortgages that permit a 50% weighting for the remaining second lien under the RBC rules and give it the advantageous 65% ASF, which might actually be reasonable for the second.
- The NSFR will combine with the LCR and the margin rules to push large banks to hold considerably more HQLAs, including agency debt and MBS. Shortages are already encouraging collateral transformation with considerable long-term and questionable impact on financial-market stability. In the meantime, though, these forces will not only advantage the GSEs, but also further complicate any exit from a USG-dominated mortgage-securitization system or the GSEs.
- Reverse repos with agency collateral receive the same asymmetric treatment provided in the Basel NSFR, making these transactions costly from a liquidity perspective in ways most banks think ill-advised. Matched-book repos are also problematic under the NPR, leading to expectations that repo volume will continue to drop in concert with transition to non-bank counterparties like insurance companies and even REITs.
- PLS get an 85% RSF – meaning that most of them must be covered by ASF if they mature in more than one year, with this treatment interestingly also applied to covered bonds. We are not surprised by the tough treatment of PLS, but that for covered bonds is striking until one remembers that the FDIC doesn't like these instruments one little bit. As previously noted, the FDIC believes covered bonds impair its recovery costs in a bank failure, and the NSFR thus creates a liquidity counter-balance to some of the incentives previously noted in the capital rules for covered-bond issuance in the U.S.
- A really rigorous RSF applies to any asset that is past due by more than 90 days in non-accrual. This requirement runs bang into the CFPB's mortgage-servicing standards, which can force servicers to hold on to loans well past 90 days in hopes of turning them around. MSRs aren't of course the same as on-balance sheet mortgages, but we expect these combined with the cost of servicer cash advances under the liquidity rules to push loans to foreclosure as

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fast as possible under the Bureau's rules and to transfer higher-risk servicing to non-banks – assuming any are around to take it on – for bank originations.

Outlook

Comments on the NSFR are due by August 5. We expect large U.S. banks to put up a strong campaign against this NPR, in part due to all the other liquidity rules to which it adds and the cumulative cost of compliance. This, big banks fear, will force them to gather large stocks of core deposits precisely at the time when rates rise and push these funds into competing alternative products that, combined with interest-rate increases, adversely affect profitability unless or until traditional loan product rates rise as well.

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