GSE Activity Report

Wednesday, April 18, 2018

CCAR's New Direction

Summary

As we noted in our assessment of the ground-breaking proposal to rewrite the GSIB leverage ratio, the big-bank regulatory framework has also been upended by a companion Fed proposal to rewrite its capital rules and, as a result, redesign the CCAR stress test that is now usually the biggest banks' most binding capital constraint. Based on our recent in-depth analysis of this proposal, we here go into detail on how it interacts with the new leverage approach and what the sum total of these rules would mean for U.S. residential finance. In short, the proposed approach reverses key regulatory disincentives to big bank mortgage origination, credit enhancement and securitization.

Impact

First, an explainer in brief of the latest, complex proposals (the CCAR one alone comes to 104 pages). Like the companion NPR to redesign the enhanced supplementary leverage ratio (eSLR) for the biggest banks, the new capital/CCAR one has been described as a clear sign of the new hand Trump appointees have at the Fed. They do indeed have the new and upper hand, but both of these proposals are in fact premised on lengthy plans that the arch-enemy of the big banks, Dan Tarullo, hatched shortly before he stepped down last year. While both proposals reduce regulatory burden to some extent, the only real beneficiaries are sure to be large, non-complex regional BHCs – not the GSIBs that the Fed still has clearly in its target not only for tough rules, but also even for *de facto* fragmentation wherever possible.

The common thread between the eSLR rule and the new capital/CCAR NPR is linkage to CCAR stress-test results. This is done to achieve the Fed's over-arching objective: to reinstate risk-based – not leverage – capital as the binding constraint for all but the custody banks.

The capital/CCAR proposal moves the Fed's ball forward by rewriting the underlying capital framework for BHCs with assets over $50 billion (i.e., those subject to the Fed's strict stress test). Putting it as simply as we can, the new framework creates stress risk-based and stress-leverage buffers linked to the BHC's performance under each year's CCAR stress test. The BHC would thus be subject to a point-in-time qualitative judgment by the Fed on how well the company's capital-distribution plans stand up in the face of the Fed's severely-adverse scenario, but also to ongoing, dynamic ups and downs for both risk-based and

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com www.fedfin.com

© 2018 Federal Financial Analytics. All Rights Reserved.

leverage capital based on the company's actual experience.

What then is each BHC's binding constraint? As is now the case, the basic building block is first how well the BHC does under either the standardized or advanced approach to risk-based capital (with only BHCs with assets over $250 billion subject to the advanced approach). From there, the BHC looks ahead to where this capital ratio plus at least 2.5% puts it one year out in the CCAR severely-adverse stress scenario after assuming that planned stock paid dividends are paid, with the BHC then required to hold this buffer amount of risk-based or leverage capital. If the BHC is a GSIB, it gets kicked in the teeth with an additional "capital-conservation buffer" atop these initial stressed ratios based on its GSIB risk-based surcharge, the eSLR, and any counter-cyclical capital charge that might then be in effect.

Outlook

With this primer – we swear, the actual rules are far more dense – what does this mean for U.S. residential finance? We here lay out the capital impact of these changes and their strategic result, but caution that even this is an over-simplification. FRB Vice Chairman Quarles yesterday said that he wants to reduce current liquidity rules for all but the biggest BHCs. This too has strategic mortgage impact and an interplay with the capital discussion below. We'll turn to it in a forthcoming analysis.

First and foremost, the reinstatement of risk-based capital and the way CCAR then sets the actual requirement above and beyond the initial regulatory calculation means that current capital incentives to game the leverage ratio are reduced and perhaps even eliminated for the very biggest BHCs. We've written a lot about the unintended impact of the leverage ratio on market liquidity and mortgage lending, and this approach will ameliorate if not altogether correct for it by premising even the eSLR on stress-test performance. Thus, this approach should overturn the current incentive to game risk-based and leverage rules by holding higher-risk, higher-return assets on which profits are possible despite the current, very high leverage ratios for the biggest BHCs.

The biggest BHCs on which the market once depended will thus be far better able to portfolio lower-risk mortgages and credit enhancements. Higher-risk loans – e.g., to first-time homeowners, non-QMs, etc. – are also facilitated because the BHC does not have to charge what is essentially a predatory price on the mortgage to make it make capital sense.

Conversely, stress testing should capture higher-risk positions such as high-LTV mortgages, cash-out refis, HELOCs, and first-loss tranches that somehow now escape the basic risk weightings. Just as incentives to book higher-risk positions that make the eSLR make sense are reduced by more risk-sensitive, stressed risk-based capital, so too should this approach capture higher-risk positions now priced or otherwise structured to meet ROE goals. Where the stress tests now preempt risk weightings – e.g., with regard to MI recognition – this, rather than the current weightings will determine holdings for all large BHCs. Where agency obligations carry interest-rate risk captured by CCAR or operational risk (e.g., put-backs) similarly caught in CCAR but not weightings or the leverage ratio, these too will drive portfolio allocation even if the underlying asset has a zero or 20% agency weighting – price and fees of course taken into account. The biggest BHCs would also be better positioned for a far larger role in mortgage securitization with or without the GSEs

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail : info@fedfin.com www.fedfin.com

© 2018 Federal Financial Analytics. All Rights Reserved.

because large books of low-risk mortgage guarantees likely would not come under punitive leverage ratios

To be sure, risk-based capital rules retain the harsh treatment of mortgage-servicing assets (MSAs) that has now sharply constrained a lot of big-bank mortgage activities. It is possible that CCAR could overcome this problem by down-grading the actual impact of the MSA after its stress scenarios are layered on to the basic risk weightings. Or, of course, CCAR could make MSA weightings till more painful.

All of these questions will first be addressed in the deluge of comments sure to befall the Fed. The final standards as enacted and how they relate to any new liquidity rules will of course determine final impact, but it's already clear that the banking landscape for mortgage origination, credit enhancement, and securitization is set for a way big change of game.

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail : info@fedfin.com www.fedfin.com

© 2018 Federal Financial Analytics. All Rights Reserved.