GSE Activity Report

Thursday, June 14, 2018

Why Some is Better than None, But Just for Now

Summary

As promised, FHFA has disclosed the post-conservatorship capital standards. Although FHFA's proposal and subsequent press coverage highlighted the $181 billion in capital the GSEs would have to scrounge up under the new rules – a bit of a challenge given their combined $6 billion in actual capital – the new standards are still no more than half of the capital required of large U.S. banks despite FHFA's assertion that its proposal is generally consistent with bank rules. This is true only if bank regulators bought all the reasons FHFA thinks the GSEs and their successors are less risky than even the very biggest banks – which they won't. Although we doubt this framework would carry over to GSE successors, it will be a significant constraint on conservatorship pricing and products and, depending on transaction structure, a boost to MI and CRT.

Impact

FHFA justifies its sharp differences with relevant large-bank capital standards in part because it thinks mortgages are safer than the assets banks hold. However, the risk-weighting "density" factors FHFA cites in the NPR omit mention of the fact that large banks hold about 30% of their portfolios in zero-weighted assets and agency paper that sharply reduces risk relative to the 50% risk-weighting for mortgages that FHFA rejects as too high for Fannie and Freddie. FHFA also argues for a different approach because GSE funding is, it says, more stable – true, but due not to virtue, but to the fact that the GSEs have an effective USG guarantee and even the biggest banks are now assumed by counterparties to be subject to failure.

To understand both risk-based capital (RBC) and the leverage ratio (LR), one has first to consider the numerator – what counts as capital – and then the denominator – how assets are defined – before turning to the percentages of capital versus assets. On each of these three factors, FHFA takes the easy way out. The new framework is a lot more than the GSEs hold now or than they were required to hold by OFHEO (for all the good that did). But the comparison with large banks shows numerous differences with significant cumulative impact. This ensures that GSEs or their successors under FHFA's capital regime would dominate U.S. housing finance even after a transitional period.

First, to capital. Here, FHFA has law on its side. The 1992 GSE law – crafted by experts mostly at the GSEs – defines capital to include "core" elements now only partially recognized by the banking agencies and loan-loss reserves that are still largely outside the bank numerator despite new CECL accounting rules with significant adverse implications for bank capitalization. Given CECL, we think it makes sense to include loan-loss reserves as Tier 1 or "core" capital, but bank regulators so far

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

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refuse to do so, making FHFA's framework significantly less costly.

Now to FHFA's lenient denominator. One reason FHFA thinks GSEs are a lot less risky than big banks derives from all the credit-risk transfers, but banks can and do engage in CRTs. The difference is that bank regulators think risk is only transferred when the mitigator taking it on can in fact absorb it under stress. Pricing for risk and even holding cash reserves against risk do not count for capital reductions under the banking-agency or Basel rules. FHFA does have a complex scheme designed to capture counterparty risk which may indeed do a better job here for MIs and CRTs than the far more traditional approach taken in the banking rules. However, due to this, the capital discounts provided for CRT may be minimal; it all depends on the deal structure and how it scores. CRT structures will determine how well this aligns taxpayer and capital incentives, but leaves the GSEs or their successors as very large institutions subject to the market's willingness to continue to take higher-risk tranches even under stress scenarios.

FHFA has redesigned its denominator to follow the banking-agency practice related to cash and MBS guarantees, with this change along with the new percentages (see below) making the proposed LR a lot tougher than the current GSE rule but still far more lenient than those governing all U.S. banks, let alone the biggest ones. FHFA brings the MBS guarantees on balance sheet in concert with setting the denominator for both RBC and LR in accordance with accounting standards. Cash thus comes in for the LR as do extensions of credit to insured depositories and all other on- and off-balance sheet assets.

Turning to RBC percentages, FHFA first eschews any of the buffers – including the binding ones imposed on big banks from stress tests – on grounds that its rules are tough enough. The 50% risk weighting is deemed too stringent for GSE mortgage obligations on grounds that banks have to hold this standardized weighting even for whole loans that could well be riskier. In fact, this is true only for small banks; large banks have to hold the higher of the standardized or advanced weightings and thus must weight whole loans higher if the advanced approach thinks them riskier. The 50% weighting is a floor, not a ceiling. Maybe all the GSEs' loans are safer than those booked by banks, but recent DTI and LTV products make this at least open to question.

The new RBC standards cover credit, market, and operational risk, subsuming counterparty risk in the credit-risk category and giving MI and other loan-level enhancement capital credit based on various characteristics (e.g., if MI is cancellable, correlation risk, loan characteristics). This is similar to the big-bank advanced-approach RBC framework in construct, but strikingly different than it in detail. For example, the framework not only credits CRT as discussed above, but also uses spread – not value-at-risk – for market risk. Operational risk is backed with an 8 basis point capital requirement, a far more lenient standard than those imposed by the U.S. on large banks or the ops-risk framework recently finalized by the Basel Committee. A buffer requirement on all assets ensures that even the best weighting under the complex scale FHFA proposes cannot fall below 75 bps, but this is less than one percent of capital and thus far less than the 5% of RBC banks hold under the 50% weighting, let alone all the higher requirements on riskier mortgages. The only assets on bank balance sheets that get anything close to a 75 bps charge are Treasury obligations under the zero weighting (although these are still captured by the 5% or higher bank leverage requirements).

FHFA clearly recognizes that its RBC rules are relaxed. It believes its leverage ratios control for this. Two alternatives are proposed – a 2.5% percent LR would cover all on-balance sheet obligations and guarantees and a "bifurcated" alternative, under which the GSEs would have to hold 1.5% against "trust assets" – i.e., MBS and guarantees and 4% against "non-trust" assets, which are everything else minus trust assets.

These LRs are particularly important since, as FHFA readily recognizes, its RBC standards are even more procyclical than the big-bank advanced approach. It has nonetheless set the LR lower than that imposed on big banks on grounds that an overly-stringent LR would create risk-taking incentives.

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

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LRs do indeed have this effect but only if they are set high and RBC is unduly low for riskier assets. A low LR and a lenient RBC creates still more powerful risk-taking incentives because neither rule captures higher-risk obligations absent buffers or binding stress tests. FHFA also seems to believe that its LR makes sense because the GSEs have low liquidity risk, but this is as noted due largely to their quasi-governmental status and in any case has no direct bearing on credit risk. Also of note: the GSEs are exempt from virtually every prudential and resolution rule governing big banks, which makes regulatory capital still more critical for the GSEs.

Outlook

FHFA defends this framework on grounds that it would have kept the GSEs above water in 2008, and so it might at least far more than OFHEO's earlier, indulgent rues clearly did. However, the banking agencies do not posit their regulatory-capital standards on crisis experience, but on continuing updates intended to take changing conditions and other rules into account. They do not always do so well – we have long castigated the double whammy of the LR and liquidity requirements – but the banking-agency standards are at least an attempt at forward-looking analysis. For better or worse and certainly at great cost to big banks, scenarios of factors such as crisis house-price depreciation are constantly revised, not kept largely as they were in the crisis as FHFA chooses to do.

The most treacherous aspect of the new standards are the comparatively low risk-based weightings. Still, the new approach adds long-overdue capital discipline to the conservatorships. Even though capital retained by the risk-mitigating efforts of the new standards would go to Treasury, they nonetheless provide important boundaries on GSE risk tolerances and new-product ambitions.

What would this framework due for the limited-life regulated entities (LLREs) or even truly privatized firms that would follow a GSE receivership? Clearly, they could add a lot of capital – considerably more than demanded now of the GSEs under these rules – because none of these entities is an agency and thus would enjoy government-backed pricing and market-resilience advantages. Even so, these new GSEs would have strong capital-arbitrage advantages over U.S. banks big and small. We thus expect that the differences between FHFA's rule and the large-bank rules – Basel and U.S. – would dissuade Treasury from adopting them on a going-forward basis or lead any primary regulator of private GSE successors to adopt them. Wall Street will love this option; big banks, not so much.

FHFA's proposal is thus a holding pattern that makes Fannie and Freddie safer than they would otherwise be without a real regulatory-capital buffer. What they mean for the future of U.S. housing finance depends first on whether they are carried forward and, if so, under what transitional arrangements in what types of companies with how much of a federal backstop. FHFA's approach thus is better, but not yet ready for real implementation for any GSE successors taking even more risk than Fannie and Freddie do now.

NOTE: This report provides a set of conclusions based on a complex proposal. It therefore does not go into detail on product, provider, counterparty, or borrower impact. Due to the complexity of the rule, these vary based on applicable factors. If you have any questions please do not hesitate to call or reply by return email.

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Phone (202) 589-0880 Fax: (202) 589-0423
E-mail : info@fedfin.com www.fedfin.com

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