GSE Activity Report

Monday, November 23, 2020

No Neutral Zone

Summary

In this report, we build on our initial summary of FHFA's final capital construct to assess one of the most important issues on which FHFA made at least some concessions: CRT. However, no matter these concessions, the final rule still makes it more capital-efficient for a GSE to hold a position on its books than to transfer some or all of its risk in synthetic structures. Although the final approach is still more liberal than the rules governing like-kind bank CRT structures, it will surely impede GSE risk transfers and thus anger those such as Freddie Mac and many on the Street pressing for the GSEs to become capital-market players. The final rule somewhat liberalizes capital treatment for MI exposures and remains considerably more favorable than the banking construct, adding a bit more incentive for straight forward securitization or, over time, perhaps also front-end CRT.

Impact

Concessions notwithstanding, FHFA is clearly anxious about CRT on operational risk, regulatory-arbitrage, model-weakness, implicit recourse, and – in light of recent COVID analyses – because many CRT investors are highly-leveraged hedge funds and highly-leveraged funds played a significant, adverse role in the dash for cash. At its root, the rule still prefers equity financing to CRT, although CRT is still favored over MI to the extent one can tell from the gross totals provided by FHFA on single-family mortgage relative RWAs. Key provisions in the final rule include:

- The 10% minimum risk weight remains on retained CRT positions. As with the other risk floors throughout the final rule, this one is a *de facto* leverage charge since it is risk neutral. Its effect is thus to increase risk-taking incentives, especially when combined with the overarching leverage ratio across all GSE exposures that may well be a back-up charge under the final rule's calculations only because *de facto* LRs such as this one are counted as risk-based capital.
- The floor also created concern that some higher-risk CRT positions could get disproportionately lower weightings. In response, the final rule realigns risk weightings across all CRT tranches, slightly increasing capital for certain positions.
- The "effectiveness buffer" also reduces risk-weighted assets in CRT, essentially discounting the transactions to accomplish FHFA's objective of equity-financing, not CRT, risk buffers. In the final rule, the agency has retained this belt-and-suspenders requirement, but reduced it and in some cases will even waive it. However, because of the way the effectiveness-buffer deductions are calculated, the revised approach creates an incentive for the GSEs to transfer lower-risk assets along established lines rather than move the riskier positions that one would

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think compatible with FHFA's overall objective of reducing GSE and thus taxpayer risk. It remains to be seen the extent to which the risk floor and effectiveness buffer combine to result in CRT adverse selection.

- The final rule also retains the proposed, conservative approach to reducing CRT positions based on counterparties, continuing to favor diversified insurers and reinsurers over monoline MIs. Collateral continues to be counted at the lender, not counterparty, level.
- The final rule does not leave future CRT structures solely to FHFA's discretion. Instead, five CRT constructs eligible for capital relief track those already in the market. Since this approach fixes approved CRT in rule, new CRT options that FHFA might come to favor would require a change in rule under the lengthy APA notice-and-comment procedures that could stifle innovation.

As noted, the final rule is gentler on MI. As we have said in the past, the bank rules recognize MI for standardized weightings, but not as eligible advanced-approach credit risk. CCAR stress tests and thus the banks' SCB also does not give MI credit because the banking agencies continue to distrust its monoline structure. FHFA has raised significant worries about this, but nonetheless recognizes MI for loan-level RWA calculations.

Outlook

FHFA readily concedes that the 2020 proposal would have cost the GSEs double the CRT capital relief included in the 2018 NPR. The final rule alleviates some of this burden, but FHFA disputes assertions – see for example Don Layton's post last week – that the cost of the new CRT construct is a structural barrier to taxpayer-risk reduction. It lays out the ways Fannie and Freddie could alter deal terms to change the comparison between 2018 and now, with FHFA concluding that the GSEs can optimize capital relief under the new rule and thus continue CRT in the absence of capital neutrality. The agency concedes that the collateral and counterparty provisions in the final rule might be improved, but only a future rulemaking will do so.

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