GSE Activity Report

Wednesday, June 16, 2021

A Wrench in the Crypto Works

Summary

As detailed in our new in-depth report, the Basel Committee is proposing a new regulatory framework for bank exposures to cryptoassets that will influence not only what banks do in this critical arena, but also what the GSEs can do and thus what happens to the digital mortgage. If Fannie and Freddie come under like-kind capital and liquidity rules related to their crypto exposures, digital adoption of any asset with crypto components will be slower but the system could well be safer.

Impact

Basel's proposal is intensely controversial largely because many in the crypto universe failed to see it coming. Banks not so much – for them, it provides the first note of certainty that, for all its costs and controversies, might also create a new crypto construct that not only includes regulated entities, but also favors them. In this, it eerily resembles the first Basel capital accord in 1988, which set a floor under risk-based and leverage capital and thereby stopped a race to the bottom that gave U.S. and U.K. banks a renewed competitive edge in global finance. Nonbanks and even tech-platform companies would of course remain outside the bank rules, but crypto counterparties outside the speculative and illicit-finance worlds might well prefer a cryptoasset that can deliver what it promises.

There are two sides of the crypto coin: 1) what the new standards do to those it covers; and 2) what this means for everyone else. We assume that Fannie, Freddie, and the FHLBs will see their faces on the first side of the coin because FHFA – focused as it is on more or less paralleling bank rules – will more or less model its crypto standards on either Basel's or the final U.S. versions thereof. Initial considerations include:

- What's a Digital Mortgage: The Basel rules would create three classes of cryptoassets (see above for a report on these details). At least as first, mortgage assets seem most likely to be to be considered tokenized digital assets if each loan is digitalized in more than simple electronic fashion and kept distinct from all the others as now is required for an array of legal and operational reasons. If a tokenized digital asset, then the Basel rules do not differentiate a crypto-digital mortgage from a paper mortgage in terms of minimum capital and liquidity standards as long as eligibility requirements are met (which mostly they likely would be). If MBS become digital MBS, the same like-kind rules would apply to them, but the likelihood of add-on requirements to offset complexity and other risks would rise. Any effort to pool mortgages into a single MBS akin to a stablecoin – i.e., an MBS-like asset backed by a basket of mortgages – raises still more complexity and comes with a considerably higher capital price-tag. However, if one or another rule for mortgages or MBS favors digital versus paper mortgages or if nonbanks outside the reach of these rules accelerate digital-mortgage finance, significant market reconfiguration could result.

- Digital MSAs: MSAs carry both an RBC charge (punitive for the biggest banks) and are deducted from capital at still greater cost under certain circumstances. As with mortgages, MSAs in tokenized crypto form would get like-kind capital and liquidity treatment, which includes not only the relevant weighting, but also required deduction. MSAs pose greater complexity problems than whole loans given the manner in which they are managed and might be particularly amenable to internal tokenization. However, trading MSAs across the industry using cryptoassets could require pooling that then turns the digital asset into the equivalent of a stablecoin. An array of complex risk-management and reserve balances would then come into play, likely dooming any such effort.
- MI and Credit Enhancement: Because of the like-kind capital/liquidity standards described above, loans with or without MI that are converted into cryptoassets would have MI reflected in the credit risk weighting. CRT would work the same way. Turning MI or credit enhancement into smart contracts in which the value of the CRM is the asset is also possible, with this likely falling outside the proposed framework because the contract itself isn't an asset. Of course, regulators could deem the right to credit enhancement an asset for purposes of cryptoasset coverage, but this would take a new set of standards addressing an array of credit-risk-mitigation options that is not fully addressed in the Basel proposal.

What might all this do to mortgage securitization? Basel's rules address guarantees related to cryptoassets in the same way the underlying capital rules now address all guarantees or other forms of credit enhancement: a look-through to the underlying asset and the capital calculations based on them adjusted by a credit-conversion factor reflecting the contingent position of a guarantor. As a result, the GSEs' capital requirements for crypto mortgages could be akin to those now in place for traditional mortgages but so high for non-tokenized ones as to bar them from the secondary market. How FHA would address this in its capital calculation is so wild a guess we won't even try nor can we hazard a guess as to what the VA might do. Ginnie might well, however, take an even dimmer view of nonbank capital and liquidity resilience, instituting new eligibility or other standards to insulate itself from crypto mortgages should it choose to back them.

Outlook

Nothing has been publicly heard from CSS since the announcement early in 2020 that it would lead the charge on digital mortgages. Work is of course more than well under way across the industry to do so, but CSS participation would create a huge, automatic marketplace for this form of cryptoassets that would jump-start adoption. The new Basel proposal is a significant speed-bump – not an insuperable one for tokenized loans depending on what the GSEs and Ginnie decide to do.

Comments on the Basel proposal are due by September 10.

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