



GSE Activity Report

Thursday, September 30, 2021

Crazy for CRT

Summary

Now that we have FHFA's comment deadline – November 26 – we expand our [initial analysis](#) of FHFA's capital rewrite into a more detailed assessment of its strategic impact. How key industry sectors view this new approach will very much depend on what each sector wants – those who want CRT got almost all they desired while those who want bank capital parity lost still more ground to Fannie and Freddie. Assuming the final rule advances ASAP along proposed lines – and we think it will – and combined with the [liberalized PSPA](#), CRTs will define mortgage securitization across anything close to a conventional conforming loan and all the higher-risk products the GSEs can purchase again.

Impact

As we noted earlier, the most significant changes proposed to the 2020 rule radically expand CRT's prospects and dramatically reduce the leverage ratio (LR)'s bite. This combination significantly increases the capital incentives for credit enhancement structures in which the GSEs move the highest risk ends of their books into the capital markets and/or reinsurance or even primary insurance arenas if investors come to accept CRT without a GSE first-loss tranche. However, even renewed existing structures with retained first-loss positions would be considerably more appealing because of the confluence of new capital incentives.

In the NPR, FHFA counters the 2020 rule with strong statements substantiating CRT liquidity through the cycle based on last year's experience. It also states, without providing detail, that Fannie and Freddie now plan new CRT products to optimize risk transfer and capital relief, plans now given a significant boost by the prospect of greater capital relief. Combined with the PSPA rewrite, CRT is likely to move more towards the higher-risk end of the GSE-purchase spectrum, also creating new capital incentives or at least fewer capital penalties for the equitable financing [FHFA now demands](#).

FHFA's changes to the leverage ratio reflect its standing preference – shared with the Fed – for a risk-based binding ratio. However, FHFA's compare/contrast discussion of its approach vis-à-vis that of the banking agencies contains a number of continuing discrepancies. Most notably, it says that the largest banks have a 5% LR; this is true of insured depositories, but the key, binding LR is the 6% supplemental ratio demanded of parent holding companies.

And, while the Fed did indeed ease the SLR in 2020 with regard to central-bank deposits and Treasuries, both the Fed and [global regulators](#) plan either to include them back into the denominator or raise the SLR to keep the ratio at least as high as it is now without, it is hoped, adverse impact on systemic liquidity. If this new, higher ratio is binding, the Fed appears ready to accept that in order to avoid what Gov. Brainard and progressive Democrats' fear would otherwise be undue laxity. Thus, the new FHFA leverage buffer would not just afford a good deal of capital advantage to the GSEs, but provide still more of this than allowed under the current rule.

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These structural changes to CRT and the LR are not the only major ones FHFA contemplates. Questions also seek views on whether to tackle another high-impact standard to which comments on the final rule strongly objected: the 20% risk floor on single- or multi-family exposures. As we noted, this is considerably less than the 50% minimum in the standardized approach for U.S. banks, although it is closer to the minimum weighting allowed in the new global capital standards. The U.S. has yet to turn to implementing this Basel IV package but is unlikely to allow residential-mortgage weightings to go below 35% for all but the lowest-LTV, least-risky loans.

Outlook

As we [noted](#) earlier today, the capital rewrite has not escaped political notice. When it came out, Senate Banking Chairman Brown [praised it](#); now, Ranking Member Toomey condemns it. Regardless, Treasury will keep the revised PSPA as is unless and until it gets through an array of higher-priority FSOC actions and FHFA will finalize a new capital rule that, should it differ from the proposal, do so only by giving Fannie and Freddie still more capital latitude to undertake still more CRT in an ever-wider array of housing-finance products.