GSE Activity Report

Tuesday, March 1, 2022

Capital Grease for CRT Expansion

Summary

As we noted late last week, FHFA has finalized revisions to its 2020 capital rule that most importantly lighten the GSEs' capital load and reinvigorate credit risk transfer. Deals from both Fannie and Freddie will come fast, but how furiously will depend also on externalities -- i.e., how QT redefines RMBS demand and CRT pricing, what Ukraine does to market risk-on tolerance.

Impact

This final rule largely tracks the 2021 proposal, implementing changes to the capital rule that correct what many felt to be an unintended consequence of the initial standard: a leverage buffer likely often to be the GSEs' binding constraint. Although the banking agencies continue to consider changes to the enhanced supplementary leverage ratio to prevent this for the biggest banks, even relatively modest changes remain a long way off.

By linking the GSEs' leverage buffer to their stability buffer (a proxy for the GSIB surcharge for the largest global banks), the dynamic approach is similar to the stress capital buffer governing the largest U.S. banks. However, the dynamic buffer lags actual leverage by two years, making it less procyclical than some commenters feared, but also less meaningful under actual stress.

The CRT changes are even more consequential: an RWA floor half the prior level makes this now 5% and provides an end to the overall "effectiveness" assessment of all CRT exposures. Combined with the leverage ratio changes, this creates strong capital drivers for as much CRT as possible. While this latitude may also encourage GSEs to transfer the best and keep the worst, remaining controls should mitigate this. However, there is a notable exception for first-loss positions where more favorable risk-based and leverage rules than those applied to large banks give the GSEs a continuing edge in an arena where their effective guarantee has already afforded considerable competitive advantage.

Although FHFA also proposed altering the 20% risk-weighting floor on single- and multi-family exposures and the counter-cyclical multi-family adjustment, it did not finalize wider changes to the current capital rules. FHFA decided to retain the RWA floor to ensure that risk-based capital is the GSEs' binding constraint, thereby also retaining a capital incentive for CRTs of even lower-risk mortgages. It kept the counter-cyclical multi-family buffer in place largely because solutions to its continuing problems were even more complex than the current approach; future rules may revisit this.

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Outlook

As evidenced by Fannie's first CRT deal of the season, these changes open a wide avenue from the GSEs to the capital markets when and if these are not so overwhelmed by RMBS volume freed up from Fed purchases. Near-term market capacity and pricing is thoroughly uncertain due to the combined impact of Ukraine, quantitative tightening, higher rates, and macroeconomic stress. Even so, Fannie and Freddie are formidable competitors with a zest for CRT that will surely change secondary-market configurations as conditions -- God willing -- begin to normalize.

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