**Thursday, April 07, 2022**

# Capital and CRT

## Summary

FHFA has finalized new capital rules for the GSEs designed to accelerate the credit-risk transfer the agency now deems essential for a fast-acting conservatorship exit. We continue to think that, for as long as CRT requires first-loss tranches backed by the GSEs, the GSEs will be wards of the state because a broad market for other forms of CRT cannot exist without bank participation. In 2018, we reviewed the Basel IV rules that might make this possible. With the U.S. banking agencies now finally readying to propose these standards for U.S. adoption, we review their terms, conditions, prospects, and housing-finance implications.

## Impact

The Basel IV package was finalized in 2018 in an effort to fix an array of flaws identified after the 2013 Basel standards were implemented around the world. As with other nations, the U.S. forbore many substantive changes to the U.S. regime after its own flaws surfaced in order to coordinate its fixes with the broader global order. As soon as Jay Powell is confirmed as Fed chair, the U.S. banking agencies will take up these Basel standards and, since that might be today, we bring these rules back to your attention.

The Basel IV package has four key components. These include a rewrite of the market-risk capital rules, known as the fundamental review of the trading book, that we think will get its own fundamental review if, as seems likely, commodity-market stresses unveil problems not just with the current value-at-risk construct, but also with the overall and still-tenuous process dividing the banking and trading books. The second component addresses operational risk-based capital and need not concern us now.

What matters most for CRT, and the insurers, counterparties, and investors that adore it, are the other two Basel IV components rewriting the standardized approach (SA) that sets the risk-based capital (RBC) baseline and changes to the advanced internal ratings-based (A-IRB) rules known as the advanced approach in the U.S. that must also be met by the largest U.S. banks. All big banks must meet the SA and A-IRB, but U.S. banks are also required to hold the higher of these two standards, creating a discipline on model-risk arbitrage the Basel IV standards attempt to correct in all the other countries that gave banks the option of picking the capital number they liked the best.

We will turn to what the U.S. will propose and what might then become of it below, but first to what each of these Basel IV standards means for mortgage finance.

The new standardized approach seeks to drop basic risk-weighted asset (RWA) percentages for low-risk exposures, especially those favored by public policy such as small business, government-backed infrastructure, and residential mortgages. Conversely, it raises RWAs for riskier assets – i.e., banks

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that aren't really banks and higher-risk corporates.

The big change for residential, non-investor mortgages is the SA's conversion of RWAs from their link to prudence to one triggered by LTV along with a demonstrable ability to repay and an appraisal. A major issue sure to be addressed in the U.S. is Basel's setting of LTV at loan origination rather than at each capital-setting period; U.S. regulators argued within Basel for real-time LTV calculations to capture equity extraction and we expect this to be the case at least in the initial U.S. proposals to implement Basel IV's standardized approach. However, even if U.S. concedes on LTV timing, it will surely adopt another Basel IV feature: judging LTV on a combined basis that avoids arbitrage, which was all too evident before 2008 in 80-20 structures and similar products.

Importantly, Basel allows LTV to be reduced only by compensating balances and, in some cases, qualifying MI. The U.S. standardized approach now recognizes MI, but the advanced approach does not nor is MI credited in the all-critical stress tests for the largest banks. As a result, where and how MI is credited will not only be a top-priority question for the revised SA – regulators are inclined to omit it as they tried in 2013 – but also for CRT products in which MI plays a front-end role.

The impact of Basel's changes to internal models principally includes "output floors" designed to prevent the race to the bottom that has long characterized RWAs outside the U.S. However, Basel's proposal could also cost many large banks significant capital increases if they have large trading portfolios or holdings of equities, private equity, or other tradeable assets on their banking book. CRT would almost surely fall into the category of non-traditional, unregistered securities and thus possibly require significantly higher RWAs than now factor into bank investment and trading decisions.

## Outlook

One key U.S. question raised by all these Basel proposals is whether there's any continuing need for the advanced approach. Basel now allows nations to dispense with it altogether if they adopt the new SA and, even before this was authorized, capital hawks such as former FRB Gov. Tarullo argued that the complexities of the advanced approach are unnecessary with a strong SA backed by tough stress testing. The U.S. agencies went almost this far in 2019 with the final "tailoring" scheme that allowed all but the largest or most complex banks to use only the SA and we think they might go the extra mile if the agencies can agree on other actions current officials such as Acting FDIC Chairman Gruenberg think are essential to ensure that nothing about the new scheme reduces RBC at the very biggest banks.

Although the EU is delaying Basel IV implementation and the U.S. counts mostly on stress tests to buttress the biggest banks, Basel IV includes a lot of changes the U.S. pushed hard during global negotiations. Unless or until the U.S. adopts these rules, other nations will put them off and the U.S. wants them on as soon as possible. Turmoil at the agencies combined with Fed fears that any proposal that touched bank capital could curdle Powell's nomination led to the multi-year cited above. But, once Powell has the gavel, we expect these rules to advance even in the absence of a confirmed vice chair for supervision.

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