GSE Activity Report

Monday, November 7, 2022

Don't Scare the Children

Summary

In its latest financial-stability report, the Fed is at pains to provide dozens of pages of helpful data with the few systemic-risk conclusions the Board ventures couched in careful prose designed to assure critics that the Fed knows well what's going on without expressing any views that might suggest serious trouble looms or hint that any of what it surveys will alter the Fed's course in terms of monetary policy, regulatory actions, or systemic considerations. Still, its assessment of residential housing is far more pessimistic than its last report, acknowledging for the first time that, as we warned a while back, seemingly robust amounts of borrower home equity can evaporate quickly in a high-priced market flush with high-LTV mortgages. This is an important early warning sign both for markets and of upcoming actions in areas such as mortgage risk-based capital.

Impact

The Fed's latest financial-stability report is the most evasive ever – and that's saying a lot given how many punches the Fed has pulled since it first issued these reports to counter those who complained that the Fed's approach to financial-stability policy was to miss most of what mattered and then to rescue financial markets when risk unsurprisingly got out of hand. Although the reports initially gave the Fed's bottom-line conclusion on financial stability, the central bank dropped this bit of clarity as soon as conditions began to worsen. Calling risk still of only "moderate" dimensions was clearly wrong, but saying otherwise would, the Fed feared, spook markets.

And, so it is with this report – as our in-depth analysis will shortly detail, the Fed is reluctant to say much of anything about even the most worrisome matters – e.g., Treasury-market illiquidity. However, that the Fed for the first time emphasizes residential-housing as a top worry due to an array of factors it now describes is indicative of what's going on behind its as-always tightly-closed doors. Key residential-housing points in the Fed's analysis include:

- This sector has the greatest vulnerability to valuation declines.
- Nationwide house-price to rent ratios are levelling off, but remain above peaks set in the mid-2000s, although a comparison of house prices to new rents is less elevated.
- New mortgages have skewed heavily to prime borrowers in recent years, but post-2020 "prime borrowers" may be artificially scored due to temporary inflows of government-subsidy payments, forbearance, and debt paydowns.
- Early-delinquency rates are starting to rise, although the Fed is comforted by low overall delinquencies.
- Only a tiny 1.9 percent of borrowers had negative equity in the second quarter, but about half of recently-originated purchase mortgages have LTVs of 90 or more generally associated with borrowers with somewhat lower credit scores.
- But, interest-rate risk is found to be largely irrelevant for mortgage borrowers given the huge

market slice – about 90% – with FRMs.

Outlook

As we have noted, the Fed is about to embark on a major rewrite of the 2013 U.S. bank-capital rules and U.S. big-bank standards. This will take three forms: proposals on Basel's "end-game" credit-, market-, and operational-risk standards, a tougher approach to the stress capital buffer, a request for views on how to make risk-based, leverage, and buffers make sense as a whole. One of the most hotly-contested questions will be whether the U.S. will adopt Basel's revised standardized risk-weight assessments for mortgages, which would switch from a "prudential" criterion harboring the U.S. LTV/MI-recognition construct to one premised principally on LTV. As we have noted, how this shapes out has sweeping implications for mortgage securitization, credit enhancement, and credit availability. Given the preponderance of HLTV loans and the Fed's current fears, we expect the U.S. version of the Basel rules to retain the current "gold-plated" approach as well as to include the reconsideration for MI recognition promised in the 2013 rewrite.

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