



GSE Activity Report

Thursday, January 5, 2023

End-Game Standards in the End-Time

Summary

As we previously [noted](#), the U.S. banking agencies will finally, finally, finally get around to proposing their version of the Basel IV capital rules more recently dubbed the “end-game” standards. These will come with new, unique U.S. fillips due to the tough approach to big-bank capital announced by Fed Vice Chairman Barr [strongly supported](#) by Acting Comptroller Hsu and FDIC Chairman Gruenberg along with staff at all three agencies who have been doing this a long time and seen more than a financial crisis or two. This report identifies key mortgage-finance issues with strategic impact along with what’s to become of them in the end-game.

Impact

The long delay proposing the U.S. Basel IV standards derives not from opposition to them, but instead from the political furor surrounding whom Donald Trump would nominate as Fed chair in 2017 and then again what Joe Biden would do about Jay Powell in 2021. The Fed was loathe to tackle the contentious question of bank capital during considerations of such importance to its leadership. One might with reason say that there was a good deal of time between Jay Powell’s first confirmation and then his second to tend to rules the agencies always promised were a priority, but much else intervened even as there were sharp disagreements within and among the agencies on how best to proceed at a time when Trump appointees wanted a lot of capital relief and hold-over Obama ones were stoutly opposed to it.

After Jay Powell won his second term early this year, it took months and months to confirm Barr to the capital-critical post of vice chair and the rules again were on hold. With the full Biden team now at the helm of capital policy, the rules will not only proceed, but also take a tougher turn than would have been the case in the years since Basel finalized them in 2017.

This tough turn does not, however, preclude some forms of mortgage relief. Key to the final shape of the end-game rules in the U.S. is whether total capital for most big banks stays the same or, as some prefer, goes up at least a bit. There will be much pushing and pulling within all the many provisions in the final Basel standards on credit, market, and operational risk-based capital, meaning that some asset classes could actually catch a break. As noted below, low-risk mortgages are among these winners as are banks hoping to get into the CRT game.

Most notably, residential mortgages are particularly advantaged by a lower risk-weighted assessment (RWA) for low-LTV qualified mortgages, dropping this from the current 35% Basel standardized-

approach (SA) floor – 50% in the U.S. – to 20%. This is the same RWA given to agency obligations. Thus, banks would face a more complex equation when deciding whether to portfolio a low-risk loan or sell it on to the GSEs or FHA. As we [said before](#), a lot of cherry-picking about which low-risk loans are really low-risk will surely ensue.

This isn't to say that all the mortgage going is easy. Higher-risk loans will get tougher treatment. As we've noted [before](#), LTVs in the U.S. will, as in Basel, likely be captured on a combined, current basis. MI will face a major fight to retain its current recognition as an RWA mitigant, with the U.S. agencies never much caring for this and Basel now not allowing for its recognition for loans with LTVs over 80. The Basel rules also take a tough stand on junior liens, with the U.S. standing at least as tall here given the sorry experience in the great financial crisis with piggybacks and stand-alone seconds.

As we also detailed in [2017](#), the new approach to the leverage ratio's denominator significantly changes the current exposure methodology to make it more capital efficient to hold on-balance sheet derivatives, including CDS and other credit positions. The leverage ratio also reduces the cost of financial guarantees. When it comes to a bank buying credit protection, the treatment is also more liberal, but only if rules addressing wrong-way risk and other considerations are taken into account.

Nothing in the final Basel standards dims the luster of agency MBS. But might advantageous PLS pricing offset the 20% RWA? Pricing and PLS ratings have to some extent done so in recent years, but that seems unlikely going forward under the U.S. end-game standards. These sharply increase big-bank market-risk rules for trading assets. Banks could of course hold PLS in the banking book, but RWAs here also go up, likely a lot. As a result, PLS will remain niche products at least when it comes to bank investors.

Outlook

The end-game NPR should be out by the end of the first quarter, although the agencies have given themselves runway spillover to the end of the first half. Once the end-game proposals are out for comment, the Fed will turn to Michael Barr's top priority: "holistic" capital standards that put all the end-game rules into the broader context of more stringent stress-testing and comprehensive review of the leverage ratio's impact on Treasury-market illiquidity. Much more with major mortgage-market impact is [then to come](#), but that won't come quickly and, given the problems even finalizing the end-game rules will pose, possibly not at all until well into 2024.