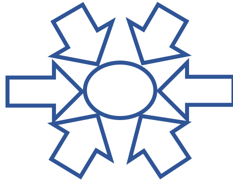

GSE Activity Report

Monday, March 20, 2023

The Collateral Damage Of The Banking Crisis

Summary

In this report, we build on FedFin's in-depth reports about recent bank failures to detail new risks for all of the innocent bystanders in the U.S. mortgage market along with a not so-innocent bystander: the Federal Home Loan Banks. We note also some take-aways FHFA may draw from the crisis with regard to GSE regulation, resolution, and supervision. In short, things will be different assuming they don't get worse and then still more of a paradigm shift.

Impact

This report will not go into detail on what happened to SVB and SBNY nor what the banking agencies, Treasury, and the White House did about it. A synopsis of these developments may be found in FedFin's initial report on the crisis as well as in our subsequent assessments of near-term changes to federal banking rules and deposit insurance. Subsequent reports will assess changes to large-bank resolution, supervision, and conduct standards along with continuing analyses of ongoing developments for as long as the banking system remains as fragile. Near-term impacts on mortgage finance already clearly include:

- ongoing Treasury-market pressure affecting not only agency-MBS pricing, but also possibly near-term market liquidity;
- liquidity stress across small and mid-sized banks if Home Loan Banks acknowledge growing political pressure over their prior lien and/or come under FHFA pressure to limit advances to weaker banks. Although FHFA cannot withdraw the statutory prior lien, it can and well may require the Banks to eliminate pre-payment penalties and other contractual provisions that increase FDIC resolution costs;
- a sharp exodus from mortgage origination, warehouse funding, correspondent activities, and securitization at weaker regional banks now focused solely on saving themselves. Assuming no additional failures, we expect sharp reductions in mortgage-related activity at all but the largest regionals as the sector reevaluates liquidity and capital adequacy in light of large HTM holdings and deposit outflow;
- reluctance by the largest regionals and GSIBs to pick up mortgage market share because of recent capacity reductions that cannot be quickly rebuilt even if management decides quickly to rebuild these operations in light of greater volume. Even where big banks are interested in long-term re-entry, near-term uncertainty about the shape of examiner demands followed by revised new capital rules will lead most companies to continue to serve existing clients, not engage or expand;

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- possible liquidity shortages for nonbank mortgage companies as banks reconsider their exposures; and
- CRT market hiccups or more severe indigestion as capital markets run for cover.

What of FHFA beyond a foot on the pedal to slow FHLB advances that put the FDIC at unnecessary resolution risk without adversely affecting overall banking-system liquidity at this trying time? Assuming the stresses outlined above remain contained, Fannie and Freddie are principally exposed to short-term liquidity risk for which they are now better prepared than was the case in 2008 absent the system-wide collapse. However, capital could be adversely affected by any AOCI recognition needed to meet liquidity demands or reflect quarter-end market valuations. These capital costs and any resulting from termination of any CRT deals are unlikely to prove so severe that the GSEs need new Treasury draws, but markets are fragile so we reserve judgment.

Outlook

If we knew, we like to think we'd be breathing far more easily.

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