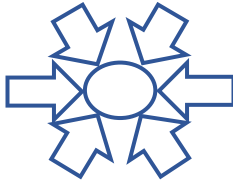

GSE Activity Report

Thursday, April 13, 2023

Another Basel Buzzsaw

Summary

As we noted earlier today, global regulators are rethinking their 2015 decision not to require an express capital charge for interest-rate risk, a shift with significant implications for the role of U.S. banks as mortgage lenders and investors. It will take if the U.S. decides on an express capital charge, but near-term developments promise immediate fixes to interest-rate and duration risk with significant strategic impact.

Impact

As we noted in 2016, Basel's decision to back away from an express IRR charge was a big mortgage-finance break. Basel did not recant the view of many global regulators when did so, dropping the idea only because opposition was growing to the rest of the Basel III accord and it thought better of pushing that fragile envelope with yet another costly requirement. However, it goes without saying that IRR and its evil cousin duration risk have risen from the S&L's grave to become a new source of systemic risk. As a result, we expect the U.S. quickly to take a series of steps to reflect them in bank capital and liquidity standards.

How? First, IRR could be addressed by an express capital charge for the banking book introduced in tandem with pending end-game trading book rules, but we doubt it due to the pressure to call the end game and the complexity of doing so. More likely will be significant shifts in which banks are forced to recognized unrealized losses – this is now required only of the biggest banks, but they will soon have company in AOCI-ville. An AOCI charge limited to securities and derivatives will drive up the cost of holding agency paper, creating incentives for banks to rely where possible on other forms of high-quality liquid assets (e.g., FHLB advances) for purposes of complying with the liquidity rules, but agency paper will still be a massive part of bank investment holdings and thus come under greater price pressure.

However, applying AOCI-related capital to loans is even more complicated than doing it for securities. As a result, another option which could advance on its own and/or in tandem with the AOCI rewrite is new risk-management rules – not just guidance anymore – that expressly require banks to hold additional capital when they are exposed to greater IRR and duration risk. This has the virtue of being specific to each bank along with the obvious flaw of being a weak read if supervisors miss signs of IRR as they seem all too often to do.

Thus, with or without AOCI and new risk-management standards, there will also be a substantive rewrite of the Fed's stress-test scenarios, scenarios that grievously failed by virtue of the Fed's decision to set risk by its always-errant dot plots, not potential market developments. Stress testing will capture loans as well as investments and do so in most unflattering ways for longer-term, lower-rate obligations. Portfolio mortgage finance could survive and even thrive despite these stress-capital buffer costs if the

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U.S. also goes with the end-game provisions providing significant RWA reductions for portfolio loans.

Outlook

In short, there are a lot of moving pieces that the Fed, OCC, and FDIC will start putting in place in new rules and guidelines as well as bank-specific supervisory actions as soon as they finish the self-reviews of SVB and Signature promised by May 1. Which pieces end where will of course depend on which banks advocate effectively for what outcome by, for example, reminding the regulators of unintended, perverse consequences with capital and liquidity rules collide, but significant toughening and tightening is still for sure.

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