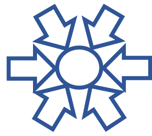

GSE Activity Report

Friday, June 30, 2023

The Ides of IRR

Summary

In non-public remarks ahead of a presentation by FedFin managing partner Karen Petrou, Sen. Jack Reed (D-RI) laid out what he thinks banking agencies will do next, doubtless based on what they've told him that they'll do next. We have predicted that new interest-rate risk (IRR) standards are high odds, but Reed's comments suggest they are a near-term for-sure.

Impact

As we noted in 2016, Basel's decision then to back away from an express IRR capital charge was a big mortgage-finance break. Few assets are as prone to both IRR and duration risk as mortgages. As a result, the higher the regulatory cost for these exposures, the less banks play in the primary and secondary markets where, nonbanks notwithstanding, they still matter a lot.

Further, that which the banking agencies do is often paralleled by FHFA. For Fannie and Freddie, IRR is less of a concern since securitization transfers this to investors and they are under strict portfolio limits, but it's still a big issue. And, for the FHLBs and longer-term advances, it's an even more significant exposure.

Basel did not recant the view of IRR risk when it backed away from IRR capital requirements, 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. Reed's comments make it clear that the banking agencies or at least the Fed are not just keenly aware of this, but also planning quickly to do something about it.

What would this be? In the U.S., 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 this course of action due to the pressure to call the end game and the complexity of doing so. Further, Reed was very clear – as indeed regulators are likely to be – that IRR-management problems are also deadly when it comes to the banking book – see SVB if there's any doubt about that.

More likely than yet another controversial capital charge that goes beyond Basel 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. Current standards dating back to 2003 require U.S. banks only to decide for themselves what IRR parameters make sense and then to do their darnedest to stay within them. Under the new approach, large banks will be given express IRR-tolerance calculations related to both liquidity and capital and then become subject to express supervisory sanction if risk goes beyond specified ranges. A lot more IRR hedging would quickly follow as would portfolio realignment wherever possible.

Outlook

New IRR risk-management standards could cut into new capital benefits for portfolio mortgages, but

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com

© 2023 Federal Financial Analytics. All Rights Reserved.

we doubt it will make a significant dent in larger books if the new standardized capital incentives suffice. This will become clear only when the end-game proposal is upon us and we also see the extent to which AOCI capitalization standards affect loans as well as securities. We doubt it because sweeping AOCI recognition on the asset side would require express recognition also for liabilities and models and markets are nowhere near ready for that, but there's far too much in play at present to provide a blanket bottom-line forecast for the full range of primary and secondary mortgage instruments, institutions, and wannabes. FedFin will of course provide holistic analyses, but only when more facts are in hand – i.e., soon.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com

© 2023 Federal Financial Analytics. All Rights Reserved.