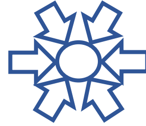
Rising Rates, Failing Banks, and Rigorous Rules:
The future of Mortgage Finance in the New Policy Paradigm



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- Traditional drivers of business success such as pricing acumen and relationship management still drive margin, but policy outcomes determine the future.
- Significant instability and market volatility remain acute challenges.
- Near-term capital changes will alter the mortgage-finance competitive landscape.
- M&A decisions based on emerging policy are a top near-term priority.
- Firewalls between banks and nonbanks to address systemic-risk worries are in the works, realigning the value of bank and nonbank charters.

Given that we're in such a lovely spot, I wish I had so little to talk to you about that we could all enjoy it a great deal more. However, as you know all too well, these are unsettled times for investors and financial institutions in general and for mortgage investors and companies in particular. As a result, I'll first review the most critical of recent events and then describe the challenges these present in the near-term. I'll also suggest some strategic responses, looking forward to a more in-depth exploration of these options when we switch to the chat to which I very much look forward.

Whither U.S. Banking?

I know that only some of you here this morning are bankers in the sense of heading mortgage operations in an entity chartered as a bank, but I think everyone of you in both the single- and multi-

family sectors cares deeply about what's happening to U.S. banks given the vital inter-connections between banks and mortgage finance essential for an array of franchise-critical functions.

The first and most critical question is whether banking and especially regional banking has stabilized since Silicon Valley, Signature, and First Republic's failures. Here, the answer is that the situation is stable, but neither solid nor secure.

How to tell? The best indicator of bank fragility is no longer deposit outflows – the de facto U.S. promise to protect all deposits all of the time for at least a little more time took care of that. Further, deposit outflows are as much an artifact of higher rates as depositor fears. What matters isn't how many deposits a bank has, but how it funds its obligations and whether doing so under stress adversely affect its capital ratios. Because all too many regional banks relied on held-to-maturity assets with significant unrealized losses, their capital is at great risk in a market where investors now have zero tolerance for any sign of weakness. As I've written, the banking system is now in a vise of depositor/investor negative feedback loops.

The Fed has sought to buffer these risks with a giant new backstop financing facility and banks are also making far greater use of the Home Loan Bank system. This had better work as a buffer against depositor and investor runs. So far, so good, but each day is different in the macroeconomic and political maelstrom putting severe stress on earnings at all but the largest banks.

Indeed, we're at a particularly dangerous moment even as we meet this morning. Although Congress approved the debt ceiling late last week, the Treasury will still run short of cash because it's drained its coffers to avoid default or delayed payment. Rebuilding Treasury cash will put pressure on deposit rates and bank reserves. Lower reserve levels mean less liquidity, less liquidity means greater stress, and – any way one looks at this – slower growth or worse.

Mortgage-Finance Implications

I don't need to tell you that none of this is comforting – you already know it via higher funding costs, near-record spreads, and stress in key sectors of the multi-family market. But, there's another development with near-term, direct impact to which I want also to draw your attention: regulatory-capital rewrites that could alter the way banks think about mortgage finance.

These new capital rules will come in three storm-surge waves. First, there are the "end-game" rules through which the U.S. will implement a set of rewrites to the global standards finalized by the Basel Committee in 2017. We've written a lot about how these end-game regs will affect mortgage competition, with the key-take-away that it could quickly get a lot more profitable for big banks to book targeted loans, adversely selecting the GSEs and perhaps even FHA. Most of the portfolio loans will be low-LTV, but higher-LTV loans might also be feasible based on how MI figures into the new framework.

Another capital rewrite will come later by way of the agencies' response to recent failures. Its shape is still to come but its purpose is clear: higher capital for midsized banks that serves as a meaningful deterrent to large unrealized losses incurred to game the liquidity rules. At this point, I think the new rules will only penalize securities, not loans, but how this turns out will have a significant impact on who holds how many MBS versus whole loans or structured investments should this prove a grey area.

Finally, all of the capital rules fold into the ultimate decider of big-bank strategy: stress testing. New stress-test constructs are promised but they'll take time to finalize depending on the outcome of the

revised capital rules I've just described combined with what happens in single- and multi-family housing under any stress still to come.

Buy or Be Bought?

Even though the future of regional banking remains uncertain and strategy-critical rules remain closely closeted by the banking agencies, the banks we advise have one critical decision each is carefully considering: buy or be bought?

The new rules on mid-sized banks combined with higher rates, slower growth, and continuing operational and technology expenditures put a lot of pressure on profitability over at least the next two to three years, pressure already recognized in the sharp drop in market capitalization across banks in general and mid-sized ones in particular. This means that many companies cannot grow organically out of their profitability holes soon enough to satisfy increasingly-demanding investors. At present, bank merger policy is wholly unclear, but Justice should announce its views later this month. That will then indicate how the prospects for regional-bank consolidation along with the extent to which bigger banks can undertake additional vertical integration via M&A.

Importantly, the buy or be-bought decision applies not just to franchises as a whole, but also to key lines of business. The very largest banks are barred from buying any U.S. depository outside the kind of rescue that allowed JPMorgan to scoop up a $200 billion-plus franchise via First Republic.

Banks are instead optimizing their balance sheets with targeted divestitures, with the most spectacular of these coming in their secondary-market single-family housing activities. That JPMorgan wanted First Republic is evidence that big banks want whole loans, but how many other banks will buy rather than organically grow them remains to be seen and how much of a secondary market comes from these private-label channels is even more uncertain.

For most regional banks, residential mortgages are essential and the secondary market is vital because few have developed much non-conforming or jumbo origination and servicing capacity. As a result, the buy or be-bought decision for these companies is generally – although far from only – a charter-by-charter call. Some may want to expand their mortgage capacity if new capital rules provide scope and some will be more appealing acquisition targets for nonbanks willing to become bank holding companies in exchange for low-cost funding, FHLB access, and the other benefits of being a bank. Yes, there still are some benefits and, if new barriers between bank and nonbank companies take hold, there will be still more.

FSOC's Say So

All the changes to come aren't just coming from the banking agencies. Congress and the Administration of course hold the deciding hand in U.S. financial policy. MBA staff couldn't be closer to the Congressional outlook, so I'll listen, not talk. However, from what I see, the odds for substantive legislation accomplishing any of the Democrats' goals of super-tough rules or the Republican's aim to roll back those at least as stringent to come under current law are all DOA.

However, the Administration on its own could make a big difference if the Financial Stability Oversight Council does more than talk about doing so. FSOC recently proposed two new approaches to how the U.S. addresses systemic risk: a new methodology for determining what poses financial-stability risk and a new process for designating companies that flunk this test. Many of you here have read my firm's

analyses of these proposals so I won't discuss them in any detail, but I do want to raise two key take-aways.

First, the most likely way FSOC will go when it identifies a systemic risk is not to try to get someone to regulate it directly – U.S. law does not give FSOC the power to direct federal or state regulators and, even if it urges them to do its bidding, these agencies have laws of their own that often bind their hand. As a result, the way FSOC will address systemic nonbanks is by getting its willing handmaidens – the banking agencies – to constrain inter-connections between banks – especially large ones – and an activity or entity that gives FSOC the systemic willies.

Whom might these be? The second way FSOC can constrain systemic risk is by naming names, but it's more likely to designate an activity or practice as systemic so that the banking agencies know where to draw which lines. At the meeting at which these standards were approved, FSOC named two: hedge funds and, yes, nonbank mortgage companies. In each of these sectors, there are more than a few entities of scale and thus far too many on which to impose case-by-case designation as a systemically-important financial institution and redefine the risk construct as FSOC sees it.

We haven't time to discuss in detail which mortgage inter-connections are likely to worry FSOC the most, which bank regulators can do much about. However, warehouse and liquidity lines seem ripe for sanction even should banks be willing to retain these businesses after the new capital and liquidity construct is complete. Fundamentally, federal bank regulators like systemic-scale activities such as mortgage finance under their thumb and the best way to put it there is to throttle nonbanks.

Key Strategic Challenges

Once, mortgage finance was remarkably boring. Sure, managing interest-rate and duration risk required a lot more attention than S&Ls in the 1980s were capable of, but credit risk was generally negligible and predictable. The biggest challenge of the 1990s right up to 2008 for the banks that took over after the S&Ls self-incinerated was trying to find a way to claw back the most profitable segments of the single- and multi-family businesses from the GSEs and, as the years advanced, from subprime lenders who well understood the bottom-line benefit of incentive misalignments between the primary and secondary markets. This incentive misalignment quickly infected banks and the rest is of course written in the entrails of the 2008 great financial crisis.

In the wake of that harrowing experience, the business of mortgage finance for the nation's regulated banks is one fundamentally defined by identifying areas of opportunistic regulatory arbitrage. The business for nonbanks is doing everything banks no longer wish to do and the business of regulators is, they tell us, to promulgate "like-kind rules for like-kind risk" in markets uniquely defined by the enormous impact of Fannie Mae, Freddie Mac, Ginnie Mae, and the Federal Home Loan Banks. This wouldn't be easy under any circumstances, but the business of housing finance is now also dictated by monetary policy.

We've known for years that macroeconomic forces define housing demand and delimit pricing, but policy volatility of the speed and magnitude you've experienced in the last year is virtually unprecedented. Many firms have lost their "muscle memory" about how to navigate these macroeconomic shoals even as recent market booms have created new forms of credit-risk vulnerabilities and liquidity challenges.

Is there a way through this challenging environment? Yes, as long as we understand that success now is defined as much by astute, forward-looking policy analysis and advocacy as it is by traditional pricing,

technology, and relationship management. In mortgage finance as in virtually all other financial sectors, traditional drivers of business success now dictate margin. Policy decides the future.

I know a key purpose of your meeting this week is to identify specific decision points and craft forward-looking answers. I'm very much looking forward now to our discussion.