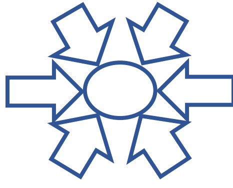

GSE Activity Report

Tuesday, July 11, 2023

Capital Call

Summary

As we detailed yesterday, FRB Vice Chair Barr laid out what he called a holistic view of bank capital standards that encompasses end-game rules, stress testing, post-SVB lessons, GSIB restrictions, and resolvability. This still isn't wholly holistic – the Fed also plans action on new liquidity rules that by inference will have significant implications for how all of these capital rules work in practice. But, even if this new regime is wholly holistic – let alone holy holistic as Mr. Barr suggests – it will have a dramatic impact on housing finance the instant it's proposed no matter continuing promises of deferred implementation. In this report, we look at what Barr said, how it affects our previous forecasts of the new capital regime, what else we know and when it all comes to pass.

Impact

The most important take-away from Barr's talk isn't news – we've said since his first holistic pronouncement that the sum total of new capital requirements would have a higher big-bank price tag. The overall impact of this isn't necessarily that there will be less credit across the land – see Karen Petrou's memo on this point on how nonbank originators and all sorts of secondary markets will pick up the profitable slack. Banks will also continue to originate all sorts of loans – single- and multi-family very much among them – but the need for capital-eligible credit enhancement, low risk-weight assessments (RWAs), and other capital drivers will gain still more importance determining which housing exposures banks take in both their banking and trading books. Likely outcomes include:

- More interest in holding mortgages and even conventional, conforming mortgages on portfolio if LTV and other risk factors make the mortgages eligible for the lower RWAs expected to make residential mortgages more capital-efficient and even GSE-competitive;
- Still more focus on secondary multi-family originations rather than direct exposures due not only to higher regulatory-capital requirements, but also increasing supervisory pressure on CRE exposures;
- Relative to current conditions, reduced big-bank aggregate trading books because capital costs associated with these exposures will go way up under the new rules. That said, agency MBS will remain attractive from a loss-of-principle and liquidity perspective under both the new standardized RWAs and those internal models still allowed in the new construct;
- New rules requiring capital recognition of AOCI may on balance have little adverse impact on large-bank willingness to hold MBS in the banking book because, once the market is cleansed of all the low-rate paper now hiding behind the AOCI filter, higher-rate AFS and/or HTM obligations will gain value when rates start to come down. We do not expect the new AOCI-related capital standards to govern long-term loans, although any effort to do that would create a strong push to ARMs;

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- The likelihood of MSA capital relief is low;
- The likelihood of higher bottom-line requirements for the very biggest banks is high, heightening the impact of all these changes across the financial sector and broader economy; and
- Given all of the above, capital-eligible credit-risk mitigation or -transfer will have still added appeal at both the loan and portfolio level. A critical question for MI is whether the end of the advanced approach spells the end of the advanced-approach ban on capital relief for CRM and CRT provided by monoline credit insurers. This is one of the many itty-bitty details in the new proposal for which we'll be watching closely given the high impact even minor footnotes can have on the franchise value of financial-services companies.

Outlook

Barr promised that the new rules will go only gradually into effect and that their combined weight is far from insuperable since it will take only two years of retained earnings for big banks to breathe easy. Doubtless due to their acute understanding of what investors think of companies without capital distributions, none of the big banks we know sees it this way and Republicans and even some Democrats feel their pain.

Most recently, the bipartisan leadership of HFSC's Financial Institutions Subcommittee told Barr to sit on the capital rules for at least sixty days until he comes before the panel. We doubt he will heed this demand given that the OCC and FDIC are good to go and the worst Members of Congress can do to them with a Democratic Senate and President is holler.

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