GSE Activity Report

Friday, July 28, 2023

Capital Winners – GSEs – and Losers – MI

Summary

We've much more to do to determine the strategic and policy impact of the new credit-, market-, and operational-risk capital rules singly and collectively – a complex task given the 1,089-page rulemaking made harder by some extremely-arcane language that may either mask what the agencies mean or differ from what they meant to mean. Still, several conclusions about mortgage finance are clear: the rules would be less demanding than those at present for many mid-LTV loans, the GSEs' risk weighting continue to give them a considerable advantage over bank originators and securitizes, and MI lost the limited luster the banking agencies were forced to concede in 2013.

Impact

First to some key points and then to how these hang together – to the extent they do – to define the proposed mortgage-capital framework. That it's not set in stone is what was made clear yesterday; thus, we also forecast what's likely to come as analysis continues and politics wages on. We will turn also to the broader market implications of the proposed approaches to market and operational risk, but credit risk is the predominant driver of regulatory capital in this sector. It lines up as follows:

- In broad terms, the risk-weight assessments (RWAs) that drive asset allocation are more favorable than the current approach, but it's not that easy. As the following makes clear, LTV is destiny along with whether a loan is "prudent."
- RWAs are set between 40 and 90 percent based on LTVs, with LTVs over 90 and imprudent loans at whatever LTV subject to a 100% RWA. For context, the current standardized approach (SA) allows a 50% RWA for loans below 80 and for over-80 LTVs if there is MI; most other loans get a 100% RWA. In general, prudence is determined by QM status unless underwriting is based on cash flow (where other RWAs apply).
- Bigger banks would appear to be getting a big break, but in fact the details of the proposal lead us to curb your enthusiasm. Big banks must hold the higher of the current, "general" SA or the new, "expanded" SA. Thus, loans with LTVs between zero and 50 percent eligible for the 40% RWA would in fact need to come under the old, 50% ratio, but loans with LTVs up to 80% could likely get favorable weightings even without MI, giving banks more opportunities to portfolio loans versus being forced to sell them to the GSEs. Why the rules require banks to hold the higher of two ratios set by the regulators and thus impregnable to gaming is one of the big questions we'll have about whether these rules even make sense, but what we say here is what they would do as proposed and that's a lot.
- On the other hand, all banks with assets over $100 billion would now be subject to the 25% capital limit on MSAs. For many, this will pose more of an issue to continued securitization than portfolio

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lending, but it's still a strategic consideration for banks and, of course, also for nonbank servicers who may do still better thanks to this requirement.

- As noted, MI is no longer eligible CRM. The agencies long prescribed this at the advanced level for the biggest banks via a prohibition on capital credit for monoline credit insurers. This would now be applicable for all banks over $100 billion under this rule on grounds that concentrated risk is too much risk and because the agencies still hold a grudge for all the MI rescissions in the great financial crisis. Of course, MI is still a required credit enhancement for GSE purchases, so all is not lost.
- The capital rationale of big-bank and especially very big-bank portfolio and securitization activities versus continuing just to sell loans is complicated by the new 40% RWA for exposures to the lowest-risk banks and higher RWAs for banks with less stellar capital or home-country regulatory regimes. In broad terms, GSEs will always beat banks because the GSEs' weighting remains 20% and Ginnie is queen of the hop because it rates a zero RWA by virtue of being a full-faith-and-credit USG obligation.
- And, don't forget the leverage ratio. It remains in full force for all of the biggest banks, with the supplementary, more stringent one now applicable also to banks between $100 and $250 billion. The big impact of this is that smaller banks thinking about off-balance sheet obligations – e.g., guarantees – will now have to hold capital against these exposures, although this will still be only 3% for banks that are not GSIBs.
- What does this data dump tell you? First, that key aspects of the new approach make no analytical sense or at least we think so and others who come to agree may be able to persuade the agencies to allow the new, expanded standardized risk weightings to dictate capital. Should this prove the case, then banks will reevaluate mortgage lending because it will be more profitable. Even if it isn't, key mortgage products are new targets of capital opportunity with or without Fannie and Freddie.

Outlook

Is this as good as mortgage lenders had hoped? Absolutely not. Is it terrible for anyone other than an MI? No, especially in contrast to the current system. Will it change? Even progressive officials at the Fed are willing to consider this and questions are posed about ways to do so. You'll have until November 30 to think about this along with the rest of the rule, but advocacy is of course already in full, full swing.

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