GSE Activity Report

Thursday, August 3, 2023

Hugging Home Loan Banks

Summary

As we plow on with our in-depth analysis of the new capital proposal, we will continue to advise of key provisions in the massive rewrite with important implications for residential-mortgage finance. Late last week, we looked at the overall treatment of mortgage assets, with more to come as we parse how the mortgage-specific capital rules fit into the incentives created by the proposal as a whole. Here, we turn to an additional issue for GSEs: what happens to their debt and equity and what it means for the future of housing finance.

Impact

As we noted earlier, GSEs retained their twenty percent weighting when it comes to senior debt and guaranteed obligations. Given this and as we noted, the decision by the U.S. to eschew Basel's 20% risk weighting for low-risk mortgages in favor of a more complex, costly scheme means that it will remain capital-advantageous for banks to originate for GSE purchase, not for their portfolios. The decision to hike the risk weighting for even the lowest-risk banks from 20% to 40% also undermines the ability of banks to provide any form of mortgage or MBS backstop vis-à-vis Fannie and Freddie.

Another difference from current rules in the proposal relates to GSE equity and here we're a bit puzzled. The proposal sets a 250% risk weight for GSE preferred stock (Fannie, Freddie, FHLBs) and boosts GSE common stock – i.e., Fannie's and Freddie's to a 250% weighting. Why the agencies did so given the conservatorship is unsaid, but we expect it's because the GSEs might someday, someday be privatized and the banking agencies want to be ready.

What's less understandable is why the agencies decided to keep the 20% weighting for Home Loan Bank equity when they went to the trouble of fixing Fannie's and Freddie's. FHLB members are supposed to be at risk – the implicit guarantee applies only to Cos, not equity positions. To be sure, the Home Loan Banks are cuddled in a cocoon of their quasi-GSE status, but the Fed and other banking agencies have nonetheless looked askance at the risks the System runs and the prior lien it very much enjoys. We expected to see FHLB equity taken down a notch with a higher capital requirement, but we were proved wrong in the proposal.

Outlook

One reason for continuing FHLB equity advantage is all the community-bank members for whom the banking agencies want nothing bad to befall. However, nothing in this proposal affects them – just

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

banks and BHCs with assets over $100 billion. Many midsized regionals are super-active Home Loan Banks members – more so now than ever, of course. It's possible that a higher risk weight for Home Loan Banks stock would have led some banks – maybe the very biggest with other liquidity options – to curtail Home Loan Bank investments and thus reduce Home Loan Bank capitalization. But the risk of this seems low.

Perhaps the agencies just forgot about the FHLBs, but then again perhaps they want to keep the FHLB liquidity taps running no matter the moral hazard associated with FHLB membership they know well and don't like much.

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