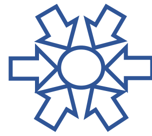

GSE Activity Report

Tuesday, August 8, 2023

Say It's Simple

Summary

Our most recent analysis of the inter-agency capital proposal focuses on significant changes to the rules for securitization and credit-risk transfer positions. In short, super-traditional securitizations have an easier path to the secondary market, but GSEs still beat banks. Complex ABS face often-formidable obstacles, as does CRT given or taken by banks.

Impact

As we noted in our assessment of the proposal's housing impact and that specific to the GSEs' remaining comparative advantage, nothing in the new framework affects Fannie and Freddie's ability to beat every other MBS issuer save Ginnie Mae. Although the new approach significantly changes the risk weighting for GSE preferred and common stock, that for its debt and thus for anything it guarantees is still 20%. Basel's "end-game" rules would have levelled this playing field for banks as well as for low-risk mortgages, but that was not to be in the gold-plated U.S. proposal. The lowest possible RWA for both banks and residential mortgages is 40%.

This is not to say, though, that banks are wholly out of the secondary-market game. A simple securitization (i.e., no more than one tranche resulting from a single credit enhancement) would get the weighting of underlying assets without the current add-on or that of the guarantor. This is also the case today, meaning that banks could hypothetically compete with the GSEs' 20% when it comes to bank MBS investor demand, but the current and proposed treatment for off-balance sheet obligations such as guarantees requires the bank issuer to set its capital for the guarantee's risk to a discounted value of the underlying assets based on a "credit conversion" factor reflecting the contingent nature of a guarantee obligation versus that of an on-balance sheet risk. To date, banks haven't found simple securitizations of non-conventional/conforming mortgages either profitable or competitive and it's hard to see the new construct making this meaningfully better.

Where the proposal makes bank secondary-market activities still more difficult relates to anything that isn't truly simple. Here, the end of the advanced approach combined with higher standardized weightings means that the biggest banks with the best capital-markets access will see the capital cost of anything truly-tranched go up. This is not just because bank MBS investors will demand a lot more for holding stakes in higher-risk tranches, but also because the bank issuer's capital related to its risk in junior tranches or CRT structures is a good deal higher and, in some cases, simply prohibitive.

Could banks rely on third-party credit enhancement in their secondary-market activities or become larger buyers of GSE-issued CRT? In short, no.

As noted, the proposal transfers the no-MI stand in the advanced approach to the new standardized-only model. It's possible banks could do some arbitrage between reflecting MI for HLTV loans or CRT in their initial mortgage-capital calculations, topping up under-capitalization compared to the new approach in the final capital ratio calculated under the new output floor. As we've noted, all these parallel calculations and compliance measures are the most complex aspect of all the proposal's complexities, with each big bank wending its way through many trade-offs to come up with as much

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capital optimization as it can.

However, it is clear that anything but a GSE-backed CRT tranche in a GSE-issued CRT isn't likely to cut it any better with banks under the new rules than it has to date. This is not only because the current rules are tough on CRT, but also because the proposal only modestly changes the risk weighting non-MI insurers would earn. This slips from 100% in the current standardized rules to 65%, a bit of a break that might make some reinsurance deals possible, but only for high-risk loans with considerably higher RWAs where pricing may well eliminate any capital advantage the U.S. accidentally bestows via the new, complex formulas for capital compliance.

Outlook

We continue to expect the banking agencies to compromise on the mortgage capital weighting at least when it comes to targeted MI and similar loans. Even if this occurs, though, it won't change the economics of all the new securitization requirements unless these are also meaningfully altered in the final rule. So far, big banks haven't targeted this section, aiming their heaviest fire at the market- and operational-risk standards. However, banks with significant interest in mortgages or hopes for covered bonds will press for at least some changes and some changes are always possible as the banking agencies calculate what they need to do to wend the final rule through a gauntlet of industry and political criticism.

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