GSE Activity Report

Monday, September 25, 2023

Bank Rules and Housing Finance

Summary

In her Congressional testimony last week, FedFin managing partner Karen Petrou focused on the unintended consequences wrought by new banking proposal based on their cumulative impact. She thus went beyond the housing-finance implications we identified in our in-depth analysis of the complex capital proposals also to assess high-impact resolution standards. In this report, we expand on her testimony and our housing-finance specific assessment of the capital rules to identify how all the other rules proposed to date alter the capital proposal's implications on its own.

Impact

Doubtless deciding that the 1,000+-page capital proposal was insufficient reform for battered big banks, the FRB, OCC, and FDIC have added new long-term debt (LTD), joint resolution, and insured-depository resolution standards. These throw hundreds of additional pages onto the pile which strategic planners now ponder, but some important housing-finance implications are already evident even in the absence of still more proposals yet to come in high-impact areas such as bank liquidity regulation.

In very short, the LTD proposal requires banking organizations and subsidiary insured depository institutions (IDIs) above $100 billion that aren't GSIBs to issue a lot of long-term debt. The idea here is that LTD creates a buffer that ensures ready resolution without bail-out even if equity is fully depleted by all the stresses that lead the bank to the brink. LTD is designed also to limit moral hazard with up-front private funds at risk in a failure that, by virtue of their long-term, "clean" construct are stuck in the bank no matter its travails.

This makes lots of theoretical sense, but how the LTD rule would work in practice is among the biggest mysteries in the missing analytics accompanying these rules. The agencies posit only a modest effect, but that's only because the calculations on which the "capital-refill" equations driving LTD requirements are assessed on current capital requirements, not those proposed in the pending capital rewrite. If capital standards go up as they surely will, then LTD demands will also go up, likely a lot.

This means nothing directly for mortgage finance in any way isolated from a bank's larger capacity to issue other forms of LTD or hold different types of risk exposures. However, the more LTD a bank must issue, the greater its propensity to hold longer-term assets in hopes of better managing interest-rate risk. All things being equal – and none of them is – this combined with more favorable capital rules for low-LTV loans would make banks more likely to hold portfolio mortgages and less likely to take on short-term exposures such as the kinds of liquidity lines and warehouse funding on which nonbank mortgage companies rely.

The joint resolution rules for banks and their holding companies were issued by the FDIC and FRB to comply with Dodd-Frank Act requirements for resolution plans focused on financial stability; the FDIC's stand-alone proposal for insured depositories is designed to speed FDIC resolutions and lower their

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cost. The two proposals overlap in key respects, but not in anywhere near as many as one might expect.

Nonetheless, the resolution rules will force a lot of structural realignment within bank holding companies and especially their IDIs, but we see few housing-finance implications beyond greater reliance on FHLB funding with far better internal procedures for identifying and isolating eligible collateral. Based on what FHFA comes to mandate for the Home Loan Banks, this could lead to greater MBS appetite, but it's far too soon to tell.

Outlook

As with the capital rules, comment on the LTD and both resolution standards is due by November 30. Banks are howling mad about much in all of these proposals, with some of it targeted on the comment deadlines. The banking agencies are steadfast in their plans to finalize commentary on the capital rules by end-November to protect final rules from Congressional repeal after the election. To give the banks some ground, the Fed and FDIC might well extend the LTD and resolution deadlines, especially given the palpable problems meaningfully calculating the LTD standards with a final capital rule at least in the agencies' sights.

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