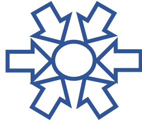

GSE Activity Report

Monday, August 14, 2023

Ax the Ops?

Summary

As Karen Petrou's memo today suggests, there are many reasons the new operational-risk framework proposed in the capital rewrite will not only be costly for covered banks, but also counterproductive for financial resilience. That said, the agencies are unlikely to rewrite it much unless the politics of the overall proposal takes the course many banks seek to the agencies' detriment. In this report, we build on our in-depth analysis of the operational risk-based capital (ORBC) proposal to go in-depth on its significant implications for mortgage origination.

Impact

As with much in the new proposal, the ORBC section is a complex paradigm of factors and observations by which the agencies believe they can judge operational risk – i.e., that related to natural disasters, fraud, system malfunction, litigation risk, and anything that isn't nailed down in credit, market, credit-valuation, or other kind of risk not captured anywhere else in the risk-based or the nominal catch-all leverage standards. In very short, key features of the opsrisk proposal would:

- judge the equivalent of the ORBC denominator based on a rolling three-year average of "business indicators" that are complex proxies for most forms of revenue – fees very much included;
- determine likely risk exposure judged by a bank's gross operational risk over the past ten years. Regulators have the discretion to align the capital charge more closely to the bank's actual risk resulting from significant changes to its revenue streams and actions taken in response to experienced risks, but they needn't do so. Further, banks that have wisely (or so we think) updated their operational risk infrastructure to anticipate emerging risks get no capital credit for doing so; and
- consistent with their disdain for internal models, the agencies eliminate the current, models-based "advanced measurement approach" that sets ORBC for the very biggest banks. Going forward, all banking organizations with assets over $100 billion would come under the new, standardized ORBC framework unless supervisors used the discretion afforded elsewhere in the rule to modify standards based on a bank's profile. So the proposal says, but so it won't work in broad enough terms to exempt any covered bank from the ORBC framework in general even though little fiddles for the smallest covered banks are possible.

What does this mean for mortgages? The ORBC standards have none of the direct impact on- or off-balance sheet exposures demanded by the credit-risk rules or, for trading assets, the significantly revised market-risk requirements (see forthcoming in-depth reports). Still, they pack a very, very significant punch, forming the largest part of regulatory capital for banks focused on fee-based activities still required to hold capital under both the risk-based and leverage rules for all their assets. Because most fee-based banks still have lots of assets – albeit often only low-risk, low-capital ones such as central-bank reserves and treasuries – ORBC is their primary risk-based requirement that must be

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topped up for risk-based purposes regardless of their often-binding leverage ratio.

Banks active in mortgage securitization of course do so because the fee income makes it worthwhile taking current risk-based and leverage rules into account. One reason GSIBs have gotten wholly out of the mortgage business – not just portfolio holdings – is the adverse consequence of the current ORBC charge combined with that for MSAs. One reason regional banks might follow suit is the new ORBC rule along with all the other capital charges.

For more, see Petrou's Congressional testimony the last time this proposal came round. Then, the banking agencies thought better of much of it and opted for models; now, not so much.

Outlook

As we've noted, each bank's decision about each business line will be based on complex trade-offs between the current standardized approach (SA) and the expanded one for credit risk, the impact of the opsrisk and market-risk rules, how all of the capital charges add up for the new "output floor," and where money can best be made. It seems likely that mortgage-origination fee income would need to go up from current first-lien levels, but how much and how continuing to sell loans to Fannie, Freddie, and Ginnie comports with remaining desires to do seconds and HELOCs cannot be discerned on a sector-based assessment.

We know the new approach is in most respects costly to banks in mortgage origination, securitization, and servicing. We also know that the ORBC proposal all too often overlooked in impact assessments will make a significant difference in this market. How much is hard to say. That it's a lot and a good deal more than reflected in the interagency impact statement is for sure.

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