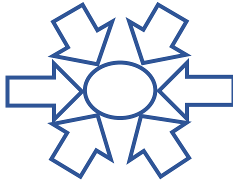

GSE Activity Report

Monday, October 2, 2023

A New Cover

Summary

As we noted earlier today, the FRB has issued a seemingly technical FAQ liberalizing the treatment of certain credit-linked notes. Fed supervised banks that find this approach appealing – and we think several big ones will – thus now have a new way to achieve risk-based capital relief for mortgages akin to certain GSE CRT products.

Impact

As we've noted, the banking agencies and most especially the FDIC don't much like covered bonds. That said, the combination of tough new capital proposals and the QRM/QM construct provide options for certain instruments if banks are able to find sufficient capital-arbitrage advantages by virtue of who is doing the covering atop the covered bond.

Even so, covered bonds have proved a challenge because of the formidable role of the GSEs and Ginnie in the QM/QRM arena. With this new Fed FAQ, obtaining capital relief for credit-linked notes just got a lot easier for state member banks and, as a result, new secondary-market structures just got easier, too.

Specifically, the new guidance provides that BHCs and state member banks can obtain capital credit via credit-linked notes if the note is issued by a bankruptcy-remote SPV which uses the cash proceeds from note issuance as collateral taken by the bank under terms applicable to other forms of collateral deemed eligible credit-risk mitigation under the capital rules governing synthetic securitizations in particular and CRM more generally. Interestingly, capital credit for credit-linked note collateral is possible even if the bank directly issues the note as long as terms of the credit derivative adhere to those otherwise required for credit-derivative capital recognition. However, notes that conform to standard documentation or are backed by a guarantee have a newly-cleared path to capital credit related to cash proceeds. The FAQs explain the Board's concerns and imply that satisfactory product design will win its heart.

However, there is no like-kind guidance from the OCC or FDIC, but we think the OCC may be amenable to capital relief now that the Fed has led the way. Until the other agencies follow suit – and the OCC is more likely to do so quickly than the FDIC – national banks could also benefit from credit-linked note structures.

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Outlook

The Fed ruling is effective immediately.

As clients know well, credit-linked notes are a significant form of capital offset across the EU, accounting for seven to twelve percent of bank credit risk according to Reuters. EU banks have ample opportunities to use covered bonds, meaning that note-related relief is above and beyond that directly related to mortgages and generally not relevant in this sector because of added cost and complexity. In the U.S., a capital offset for cash proceeds is a significant capital benefit that, newly-available for notes and given big-bank CRT plans, could become a more meaningful part of mortgage activities, especially for loans that do not qualify as QMs.

As always, though, the devil is in the capital-arbitrage calculation and that in turn is to be determined once the battle over mortgages in the capital-proposal controversy is finally resolved.

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