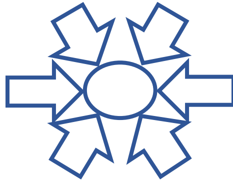

GSE Activity Report

Thursday, November 16, 2023

More for Mortgages?

Summary

As our reports on the Senate and House hearings with bank regulators made clear, our prediction that the agencies would compromise on mortgage risk-based capital requirements will prove itself in the final standards. However, it's far from clear if the compromise the agencies think will satisfy Congress will do much beyond directly addressing concerns that the proposal adversely affects LMI loans.

Impact

As our initial assessment of the proposal's credit risk provisions made clear, the agencies adopted a more stringent approach to the Basel end-game standards that rejiggered mortgage risk weightings to a 40-70% range based on LTV. This has the effect the agencies anticipated in a request for comment on hiking capital requirements for prudent mortgages with LTVs above 80% with MI that are now considered prudent loans eligible for a 50% RWA. It's also nowhere near as good as the 20% RWA Basel set for low-risk, low-LTV loans nor is it clear that even the best loans would get a 40% weighting in practice because of other requirements that banks pick the higher-of weighting when it comes to credit risk based on how all its complex calculations work out in terms of the proposal's "output floor."

Democrats have quickly picked up the agencies' commitment to revise the proposal if it's deemed problematic for LMI mortgages, getting clear indications from the Fed's Michael Barr and other agency heads that changes are more than possible. However, no one is asking for any specifics. Thus, it's possible that the agencies will give only the ground they plowed in the proposal providing favorable risk weightings only for loans to LMI households and then only in areas with majority-minority or LMI concentrations as measured under the new CRA rules. No mention is made also of the higher-of, "dual-stack" approach that could moot the benefit of a low weighting in the overall output-floor calculation. As we noted, there's no clear reason for the agencies to keep the output floor given that Basel set it to discipline banks using internal models and the new rules sharply constrain models in the market-risk rules, the only area in which models are allowed at all.

In the House hearing yesterday, Rep. Brad Sherman (D-CA) again questioned Barr on the decision to end MI reliance. Barr said nothing in the proposal changes current standards, but he's wrong. Advanced-approach banks cannot use MI and stress tests don't recognize it, but the credit-risk rules setting a bank's requirements under the standardized approach – the only one now allowed and to which the proposal compares itself – does recognize MI as noted above. Currently, an over-80 loan gets a 100% risk weighting without MI and a 50% one with coverage. Moving to the LTV-focused approach noted above is very different in the way banks set the basic construct of their lending strategy before adjustments are made to reflect stress-test parameters.

Nothing has also been said of the proposal's approach to MSA, with the rule taking a considerably tougher approach to regional banks by virtue of applying the advanced approach's stringent limits to all banks with assets over $100 billion. In concert with the other standards and even on its own, this

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stringent approach to MSAs would sharply decrease a bank's willingness not only to originate loans for its own portfolio, but also to securitize those for itself, the GSEs, or anyone else.

Outlook

The comment deadline on the overall proposal is now set for January 16, a concession from the original November 30 date. The banking agencies are now under so much pressure that it's possible that the dual-stack, higher-of construct could be dropped in favor of the proposed approach to risk weightings in which some – e.g., mortgages – go down and others go up, sometimes way up. The LMI/CRA concession also seems certain, but we think the agencies are less likely to budge on MI recognition even if called out on Barr's erroneous testimony.

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