GSE Activity Report

Wednesday, January 24, 2024

The Next Mortgage Round in the Capital End-Game

Summary

In this report, we build on our previous analyses of the mortgage implications of the pending capital rules, forecasting what's next for mortgage assets as the FRB, FDIC, and OCC wrestle with the mess Karen Petrou has elsewhere argued they brought upon themselves by careless analytics and political misjudgment. We think the odds for significant changes to mortgage risk weightings are high, but this won't be enough to quell demands for a brand-new proposal.

Impact

There are two hot-wire mortgage issues in the end-game rewrite related to credit risk – the standards for mortgage loans and MSAs – but numerous other issues are also in play as detailed below. We noted at the outset of the rulemaking that the credit risk weighted-asset (RWA) had so big a bulls-eye on it that the banking agencies promised in the proposal to reconsider its impact, albeit only for LMI households in CRA-designated assessment areas.

We had no doubt from the start that the agencies avowed willingness to compromise on some mortgages was a transparent bone-throwing exercise on an issue they knew would be a hot-wire on which they were more than willing to give even before anyone asked. The clear hope here was that a limited LMI-mortgage concession would allow the agencies to adopt the overall approach to mortgages they sought going back to 2013. Then, they were forced to concede to more lenient weightings for mortgages to save the Basel III rules; now, they will be forced to do the same for Basel IV, but it's not clear (see below) that this will work.

As our analyses of the proposal also noted, the agencies also want to toughen the capital treatment for MSAs held by banking organizations over $100 billion to the stringent ones imposed on the biggest banks that contributed to the exit of even mortgage-stalwart Wells Fargo from this sector in recent years. We expect the agencies to hold firm on MSAs, spooked as they are by volatility in this arena. There has been talk of concession here because tough MSA-capital standards would accelerate the role of nonbanks, a role the agencies don't like any better than FSOC. But the agencies have so far resolutely refused to consider product migration as a capital consideration and that won't change unless (again see below) the proposal goes back to the drawing board. Assuming it doesn't, the MSA treatment will stay, but likely only for banking organizations with assets over $250 billion as the agencies make concessions for smaller companies in hopes of saving these standards.

What of MI? Here, we think the agencies will hold to their anti-MI stance. Banks generally did not cite this shift as a concern – unsurprising since most don't use MI for their portfolio loans due to the current stress-test ban on recognizing MI as a form of loss mitigation regardless of what the current capital rules allow for smaller banks. A "moderate" number of bank respondents to a trade-association survey

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com

said that the changing treatment of credit risk mitigation options such as MI might lead them to tighten credit policy, but we doubt this will be enough to sway the agencies.

What about the proposed 40% RWA for banks while the GSEs' 20% remained, giving GSEs still more of an edge in secondary markets? Banks complained about it, but it does not top the priority list. We expect the final rule to cut banks some slack, likely with a 30% RWA, giving banks a better shot at backstopping PLS or otherwise taking on the GSEs but for all the agencies' other advantages.

A final note: all of the discussion above fails to reflect the add-on cost of the operational-risk capital standards highlighted in our earlier assessment and slammed by all of the bank comments and many of those from the Hill. It's particularly noteworthy that a key trade-association letter finds that the proposal's RWAs for loans with LTVs between seventy and ninety combined with the opsrisk add-on result in a 140% RWA for loans sold to the GSEs due to the cost imposed on fee income from the sale to the GSEs and balance-sheet charges while the loan is on the bank's books. We think the agencies will be forced to concede here as well, likely dropping the fee-based requirements to a net – not gross— calculation and even adjusting a super-controversial scaling factor to conform with Basel's more flexible approach.

Outlook

That said, nothing in the final rule will make big banks any more willing to go back into residential mortgages. Still, as noted above, all this analysis reflects key issues in the proposal that might be changed in a final rule, but this applies only if the final rule proceeds from the proposal in the usual course of rulemaking. The end-game rulemaking is anything but ordinary and we now think the odds are significantly higher than they were just a few weeks ago because of the tumult raised on the Hill. At the least, we think the Fed will need to give ground and allow public comment on the revised impact analysis Barr has promised only to release, not also put out for comment. This will slow things down, giving banks still more time to press the new cause to which they have turned: forcing a re-proposal. As we said in our initial outlook, Powell holds the key.

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2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com