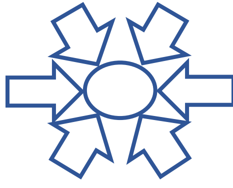

GSE Activity Report

Friday, February 16, 2024

All Stressed Out

Summary

In this report, we build on our in-depth analysis yesterday of the Fed's new stress-test scenarios to focus on their mortgage-market impact. The binding stress tests won't make portfolio mortgage finance any easier, but they also won't make it much worse. However, new "exploratory" stress tests will take interest-rate risk into account with particular attention to mortgages and MBS. That won't help.

Impact

Reflecting widespread recognition that prior stress-test rounds omitted key risks, the Fed has for the first time added two "exploratory" tests to its longstanding stress-test construct. The exploratory tests do not have the direct and immediate impact on capital-distribution capacity as the binding scenarios, but we discount the Fed's comforting assurances to large banks. The exploratory scenarios will not directly drive capital-distribution rulings, but they sure will dictate when supervisors start asking the awkward questions banks determinedly seek to avoid.

As we noted yesterday, the new severely-adverse scenarios – the ones that count when it comes to capital – in the binding tests take a slightly less severe view of house-price risk, dropping price depreciation to 36% against 4Q/23 prices from last year's 38%. The Fed's explanation says price depreciation is to be considered in markets that have experienced the greatest price appreciation, not making it clear if the 36% is a uniform scenario that should be worsened in key markets or the depth of what is expected in high-flying regions. We believe it to be the latter, but that is a guess borne of experience, not Fed clarity.

P&L expectations for mortgages are relatively positive, with the test assuming a spread between mortgage rates and ten-year Treasuries widening to 3pp by 3Q/24 before sliding to 1.6 pp at the end of the nine-month scenario. There is no mention of allowing banks to offset risk expectations via MI or monoline-insurance credit enhancement, but we expect this to remain prohibited based on the strong anti-MI policy including in the capital standards.

The new exploratory tests look at bank funding risk from a balance-sheet, not liquidity, perspective. As a result, the tests look at what happens to bank earnings if rate hikes force deposit repricing that is not offset by concomitant asset returns, focusing in particular on how rate hikes adversely affect mortgage-origination, refi, and MBS NIM. Other asset yields would also need to be considered, but the decision to single out mortgages and MBS will surely dissuade banks from these assets unless the exploratory-scenario assumptions of the adverse impact of higher rates are significantly outweighed by the binding scenario's reliance on sudden rate-drop scenarios.

Consistency is not exactly the watchword for any of these tests, where inflation assumptions also run one way in the binding test and quite another when it comes to exploratory market shocks. This may be the Fed's way of trying to reduce correlation risk due to bank credit allocations based primarily on

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how assets and liabilities perform under the binding test, but then again it could just be the Fed trying to hedge some bets when it comes to long-duration mortgages, HTM MBS, and hedge funds, which are singled out for unflattering attention in the exploratory market-shock scenario.

Outlook

Bank stress test results will be released in June. These will then factor into the stress capital buffer calculations that define binding ratios as well as expressly define bank capital-distribution capacity based on binding-test performance. Current capital rules will surely define the SCB calculation because we think it most unlikely that the pending capital rules will be finished by the end of the second quarter, meaning that all of the ratios calculated under all of these scenarios will be same-old same-old except when supervisors think otherwise.

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