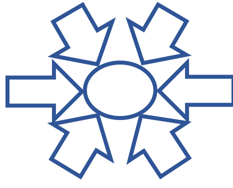

GSE Activity Report

Wednesday, September 4, 2024

What's Up with All the Rules

Summary

Now that summer is almost over, several of you have asked us if U.S. banking agencies will finally get around to finalizing all the massive proposals they have wrought since August of 2023. This note lays out what's coming when, with the fate of the long-suffering capital standards the most significant strategic challenge to U.S. housing finance. This package isn't the only one with a ticking bomb under the ribbons, but it will make the biggest bang when it's finally opened.

Analysis

Given this, first to the capital rules. As our analyses at the time note, the banking agencies over a year ago proposed a package of changes to credit, market, and operational risk-based capital with hundred-plus billion price tags for banking organizations with over $100 billion in assets. We have kept you apprised of the proposal's tortuous path through the comment process, one that is particularly political due to the fuss big banks were able to kick up among all Congressional Republicans and more than a few Democrats.

Big banks have also threatened to sue any final rules even if the final standards are significantly different from the 2023 proposal unless an intervening one puts the new approach out for comment. The Supreme Court's decisive end to Chevron gives the banks still stronger grounds on which to proceed to litigation, although deference to the agencies' read of the law governing capital standards themselves may be hard to crack given the broad discretion often afforded expressly in numerous laws in this arena. That said, there will also be the Administrative Procedure Act if substance falters.

The banking agencies are well aware of the capital rule's obstacles in the courts and on the Hill, especially at election time. There are also significant, deep divides within the FRB and FDIC over how to proceed, with only the Acting Comptroller seemingly clear on what he wants but also unable to achieve it without at least some help from the Fed. There, it seems likely that Chair Powell will continue to do his best to craft a compromise that brings Governors Bowman and Waller at least some significant portion of the way to a consensus rule. Vice Chair Barr will have to lose a lot to get this consensus, but he could well be out-numbered if Powell lays out a clear middle course. FDIC Chair Gruenberg can and will out-vote his GOP directors – that is, if he can hold on to his job until the rules go final.

Where's the housing-finance impact? Our analyses (see above) have laid this out when it comes to the proposal and also how we think it will be revised for direct mortgage-credit and servicing risk, but also for mortgage credit enhancement and credit risk transfer. No recent developments cause us to update our prior forecasts that:

- the risk weightings for residential mortgages will be eased, likely not only for LMI loans (which may get an extra break);

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- the agencies will preserve the LTV-based approach to setting RWAs, providing little if any credit for MI;
- credit risk mitigation provided by monoline providers (MIs, captives, reinsurers) will not get RWA discounts;
- regional banks may get a significant break in terms of the stringent treatment proposed for MSAs; and
- the overall cost of the final rules will be less, but not so much less that banks back off rigorous capital optimization for portfolio loans. The final rules may also apply only to banking organizations with assets over $250 billion, not the $100 billion proposed threshold.

The other major prudential proposal with housing-finance impact is by way of pending revisions to bank liquidity standards. These have yet to be proposed, but would affect bank demand for GSE debt and FHLB advances along with bank appetite for agency MBS. As laid out in our initial analyses of the housing-finance impact of the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR), bank liquidity risk banks are now required to offset liquidity risk as calculated under these ratios with holdings of "high-quality liquid assets" (HQLAs). Current rules are being revised principally to address uninsured-deposit flight and discount-window readiness in light of the severe problems experienced in the March 2023 failures, with the impact of unrealized losses on HTM portfolios addressed here as well as in the capital rules.

Implications for mortgage finance include:

- more pressure on banks to hold HQLAs, increasing demand for agency debt;
- revised treatment of FHLB advances. The bulk of restrictions on the Banks serving as lenders-of-almost-last-resort will address how this statutory privilege costs the FDIC billions in many resolutions. This will be addressed with far better coordination between FHFA and the banking agencies along with new restrictions on the Home Loan Banks. However, insured depositories with lower supervisory ratings or other indicators may also face new limits on advance use; and
- higher liquidity requirements related to HTM securities valuation marks to ensure better short-term readiness for bank asset sales. Proposed AOCI-recognition standards for unrealized securities losses are also for-sure in the capital rules and, should the whole package founder, on their own.

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