GSE Activity Report

Thursday, May 28, 2020

The Rules That Bind

Summary

Building on our initial, high-level analysis of the new FHFA capital proposal, we here go in depth into a critical part of FHFA's structural redesign: the relationship of the risk-based capital (RBC) weightings to the newly beefed-up leverage ratio (LR). We do so before assessing the new definitions of capital, the capital-conservation and systemic buffers, and much more because knowing which rule is the binding constraint is a first-order conclusion before moving on to knowing which rule bites whom how. If the LR triumphs -- as it may no matter FHFA's hope that it won't – then the incentives built into the complex RBC paradigm will be of considerably less strategic import. GSEs will still be different post-conservatorship, but they'll be differently different.

Impact

As we laid out years ago, the relationship between RBC and the LR defines strategy because the binding constraint is a critical strategic dictate, if not also its dictator. The banking agencies have long intended and recently reasserted that they believe RBC should be the binding big-bank constraint. The LR is meant principally as a risk-neutral backstop to reduce undue concentrations in sovereign assets and the inevitable limitations of both bank and regulatory models. The agencies also demand -- as FHFA now does too -- that banks hold the higher of the standardized approach (SA) to RBC or the advanced internal-ratings based (A-IRB) approach to enhance RBC's role as not just binding, but also meaningful. Like the banking agencies, FHFA has now also proposed an additional model-risk discipline: a minimum risk weighting of 15%. As a result, analysis must consider which RBC standard sets the risk-adjusted return on capital bar and then whether the LR raises it still higher.

The reason for hoping that RBC is binding is simple: a leverage ratio set too low encourages banks to hold large portfolios of low risk-weighted assets that either aren't low risk or, by virtue of really low risk, support only sovereign borrowing, not financial intermediation. Conversely, when the LR is higher than the risk-based capital charge, then banks go for risk at or above the LR minimum. Other factors – cost of capital, interest rates, operational infrastructure, credit-enhancement pricing etc. – are of course also critical, but regulatory capital sets threshold considerations for regulated financial institutions on which the rest of these costs then determine profitability.

With this background, let's look first to what FHFA's LR is and then what it would do. FHFA's new LR conforms some of the old proposal's differences with the bank construct by raising the LR to about where most banks – but not the biggest ones – must be and to include off-balance sheet assets much as is required of large banks under the supplementary leverage ratio (SLR). Interestingly and we think

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

somewhat quixotically, FHFA defends its lower LR on grounds that the GSEs hold lower-risk assets on average and thus warrant a proportionately lower LR. Of course, if risk-weighted assets (RWAs) go up – as FHFA readily acknowledges they might when conservatorship ends and caution ebbs – this rationale might no longer apply but the fixed LR still would. FHFA also acknowledges that GSE concentration risk might warrant a higher LR, seeking views on this as well as on its other differences with the banking framework.

FHFA also defends both its RBC and LR framework on grounds that the GSEs' 2019 book was so low risk that it was appropriate for the LR as proposed to prevail even though it generally shouldn't. This might make some counter-cyclical sense, but FHFA's argument – that house prices were high, CRT was robust, and counterparties were strong in 2019 -- should have made the new risk-based framework the binding constraint if mark-to-market LTV adjustments, the end to CRT as we know it, and the added charges for MI and counterparties were applied in 2019. That they were and the LR was still the 2019 constraint suggests it could prove to be the binding constraint under benign conditions and thus could prove significantly procyclical, not counter-cyclical as FHFA intends.

Outlook

What if the LR is indeed the good-time binding constraint? A lot of research with which we will not bore you lies behind the banking agencies' aversion to binding LRs. If FHFA retains the broad construct of its RBC framework and the LR is the binding top-of-cycle constraint, then GSE capital incentives will favor guaranteeing high-risk assets without CRT or third-party credit enhancement (including MI). The GSEs would also be under incentives encouraging purchase of higher-risk mortgages, redefining the conventional conforming space with significant origination impact. Under a binding LR, the GSEs would also minimize holding high-quality liquid assets on portfolio to the extent FHFA permits or, if these are required, then ramp up any fee-based, off balance-sheet activity FHFA comes to allow.

The challenge for FHFA is thus to balance RBC for mortgage risk with an LR also appropriate to large concentrations in a risk category with a thoroughly procyclical bent. It is clear that FHFA intends this outcome and its wishes might even come true if risk weightings prove the disciplinary force all its proposed weightings seek. However, the 2019 result is a disquieting real-world case in which top-of-cycle capital could well encourage still more risk-taking unless or until the market turns. The LR would then prove a counter-cyclical cushion, but not to the extent likely from a binding RBC framework with stringent benign-scenario capital charges.

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