A Comment on “FHFA Capital Rule is a step backward”

In their recent paper, Parrott, Ryan and Zandi say:

“The FHFA’s commitment to replicating much of the banks’ capital regime also appears to be behind its diminishing the viability of credit risk transfers for the GSEs, precisely as regulators have done for banks. However, it makes little sense to import the bank regulators’ approach here. In their capital treatment of credit risk transactions, banking regulators were addressing the precrisis practice of some banks using such transactions for accounting relief without actually transferring the credit risk, setting up wholly owned special purpose vehicles to take risk that would ultimately come back to the bank in a time of stress. None of the GSEs’ transactions to date carry this risk: All of them are with third parties and many of them are fully funded by cash drawn down to cover the credit risk transferred. Though it would be appropriate to reduce the GSEs’ capital relief for the kinds of transactions that have concerned bank regulators, it is difficult to see the justification reducing it for all CRTs. By unnecessarily impairing the viability of CRTs, the FHFA’s capital rule undermines the ability of the GSEs to distribute their credit risk, thus increasing their capital needs and the burden on taxpayers while they are in conservatorship.” – “FHFA Capital Rule is a step backward” by Jim Parrott, Bob Ryan, and Mark Zandi

The FHFA’s proposed Enterprise Capital Rule does diminish the viability of risk management tools like CRTs precisely as regulators have done for banks. The best solution to this unlevel playing field situation is to fix the bank regulation by providing fair capital treatment to risk management tools like duETS rather than to handicap CRTs.

duETS share characteristics with CRTS such as being fully funded with no counterparty risk. Current banking regulation makes no provisions for such instruments and constrains the capability of banks to manage the risk of their mortgage businesses. The Fed and OCC need to improve their treatment of such fully funded instruments to level the playing field.

It is counterproductive to reduce the effectiveness of a good tool that allows the GSEs to distribute their credit risk just because the banks can’t do it. The better solution is allow banks to manage their risk as well.