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Washington Policy Flash Note

Initial Basel III Reaction: Win for Mortgage Industry; Leverage Ratio Coming

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On July 2 the Board of Governors of the Federal Reserve System voted 7-0 to approve the core of its final regulatory capital rules for the nation's banks. We detail below a number of our initial takeaways from the final rule and the open meeting.

Initial Takeaways

- **Big Win for Mortgage Industry on Risk Weightings**. The story of the day from our perspective is that the Federal Reserve decided against instituting new mortgage risk-weightings. Last summer, the Fed proposed instituting new mortgage risk-weightings based on both LTV and loan characteristics which could have resulted in risk-weightings ranging from 35% to 200% (see table below). Instead of adopting these new risk-weightings, the bank regulators "decided not to adopt the proposed treatment of residential mortgages" due to concerns regarding the treatment of existing mortgage portfolios and ongoing mortgage-focused rulemaking (i.e. impact of QM and finalization of QRM). To that end, the final capital rules simply re-embrace the existing general risk-based capital rules. As the Fed's rule explains: "residential mortgage exposures secured by a first lien on a one-to-four family residential property that are prudently underwritten and that are performing according to their original terms receive a 50 percent risk weight. All other one- to four-family residential mortgage loans, including exposures secured by a junior lien on residential property, are assigned a 100 percent risk weight." We detail the differences between the proposed and final mortgage risk-weighting rules in the graphic below. In our view, the mortgage industry fared incredibly well in the final Basel III rulemaking.

The Change in Mortgage Risk-Weightings from the Proposed Rules to the Final Rules

Proposed Rule (summer 2012)

LTV Ratio	RW for Category 1	RW for Category 2
≤ 60%	35%	100%
60% -80%	50%	100%
>80% -90%	75%	150%
>90%	100%	200%

RW = Risk-weighting

Category 1—1st lien, not seriously delinquent, 30 years or less, no negative amortization, deferred, or balloon payments, full underwriting

Category 2—fail to qualify for category 1, (e.g. 2nd lien, seriously delinquent)

Final Rule (summer 2013)

20% risk-weighting: "residential mortgage guaranteed by the federal government through the" FHA or VA.

50% risk-weighting: Mortgages "secured by a first-lien on an owner-occupied or rented one-to-four family residential property that meet prudential underwriting standards, including standards relating to the loan amount as a percentage of the appraised value of the property, are not 90 days or more past due or carried on non-accrual status, and that are not restructured or modified receive a 50 percent risk weight"

100% risk-weighting: "all other residential mortgage exposures" must be assigned a 100% risk-weighting.

Source: Federal Reserve, Compass Point

- **Potential Capital Tailwind Due to Rule Change.** The difference between the proposed and final mortgage risk-weightings is meaningful and should provide an incremental tailwind to the tier 1 common equity ratio of a number of banks under Basel III. The below table lists banks with large amounts of residential mortgages as a percentage of risk-weighted assets (Basel I risk-weightings). The table shows the amount of 1-4 family residential loans that would likely be considered first liens or category 1 loans and home equity loans that would likely be considered second liens or category 2 loans per the finalized rules. The incremental change in risk-weighted assets would likely be highest for those banks with a large percentage of second liens in their loan portfolio. Additionally, we have include the corresponding change between tier 1 common equity ratio between Basel I and prior Basel III rules for the companies under our coverage (and other large cap banks). We have included this table in order to provide an indication of which banks are likely to benefit the most from the shift in the residential mortgage risk-weighting.

Residential Risk-Weighting Screen

	1-4 Family/ RWA*	Home Eq./ RWA*	Resi/ RWA*	1Q13 T1C Basel I	Basel III	Delta
EVER	55.1%	1.5%	56.6%	13.0	8.9	4.1
TCB	27.6%	15.2%	42.9%	9.2	7.7	1.5
FHN	3.9%	27.6%	31.6%	10.6	8.1	2.5
STI	19.7%	10.7%	30.4%	10.1	8.2	1.9
WFC	23.1%	6.6%	29.7%	10.4	8.4	2.0
BBT	17.9%	11.8%	29.7%	9.2	7.8	1.4
HBAN	10.5%	17.7%	28.2%	10.6	9.1	1.5
BAC	19.8%	8.0%	27.7%	10.6	9.4	1.2
RF	13.9%	12.4%	26.3%	11.2	9.1	2.1
USB	17.4%	5.6%	22.9%	9.1	8.2	0.9
MTB	14.7%	8.2%	22.9%	7.9	7.1	0.9
FITB	11.0%	8.9%	19.9%	9.7	8.9	0.8
PNC	5.4%	13.8%	19.2%	9.8	7.9	1.9
KEY	2.7%	12.7%	15.4%	11.4	10.3	1.1
ZION	10.1%	4.9%	15.0%	9.3	7.8	1.5
JPM	8.8%	6.1%	14.8%	10.2	8.9	1.3
NYCB	11.6%	0.1%	11.8%	12.0	10.5	1.5
SNV	4.1%	7.1%	11.2%	8.9	7.9	1.0
CMA	2.4%	2.3%	4.7%	10.4	9.4	1.0
Mean	**16.0%**	**7.6%**	**23.2%**			
Median	**12.8%**	**6.1%**	**22.9%**			

** Risk-weighted assets per Basel I*

Source: SNL, Company Reports, Compass Point

- **Regulators Maintain MSR Capital Treatment, Propose Longer Implementation Timeline.** Regulators decided to maintain the capital treatment of mortgage servicing rights (MSRs) but "provided a lengthy transition period to allow banking organizations to adequately plan for the new limits." Specifically, regulators maintained thresholds established in the original proposal which capped MSRs at 10% of common equity tier 1 (CET1). Furthermore, the rule states that MSRs, DTAs, and investments in common equity of non-consolidated financial institutions will be subject to an aggregate cap of 15% of CET1. As the Fed explained in its final rule: "After considering these comments, the agencies are adopting the proposed limitation on MSAs includable in common equity tier 1 capital without change in the final rule. MSAs, like other intangible assets, have long been either fully or partially excluded from regulatory capital in the United States because of the high level of uncertainty regarding the ability of banking organizations to realize value from these assets, especially under adverse financial conditions." In terms of the implementation timeline, advanced approach institution (generally banks with assets >$250 billion) will begin abiding by the implementation timeline in 2014 while all other institutions must begin complying with the phase-in timeline in 2015.

- **Little Impact to Special Servicers Pipeline.** We believe the Basel III capital and risk-weighting rules for mortgage servicing rights (MSR) will have little impact to the overall servicing market. Some of the large banks that could potentially have capital restraints from the MSR thresholds implemented through Basel III would likely continue to manage their business assuming Basel III is fully implemented. We believe the change in rules likely will not change the large banks' long-term capital plans as it relates to mortgage origination and servicing. Therefore, any large bank that was contemplating the sale of MSRs due to Basel III capital constraints would likely continue to do so. Also, we believe the vast majority of servicing that has traded over the past few years was primarily due to operational and regulatory constraints, not capital constraints. Thus, in our opinion, the finalized rules will have little impact on whether MSRs will trade or not; especially in the case of distressed servicing portfolios.

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- **Higher Leverage Ratio Not Included Today but Back in Focus Next Week**. The Fed decided not to finalize its higher leverage ratio for the nation's biggest banks during this rulemaking. During the meeting, Gov. Tarullo stated that "we are very close to completion of a notice of proposed rulemaking that will establish a leverage ratio threshold for these firms above the Basel III required minimum." Notably, the FDIC announced today that it will hold a meeting on July 9 to consider capital rules but is doing so only as an "interim final rule" rather than as a "final rule." We believe that the FDIC has undertaken this procedural step in order to facilitate a more official consideration of a higher supplementary leverage ratio for the nation's largest banks. Ultimately, we believe that the nation's eight global systemically important banks (G-SIBs) will face a supplementary leverage ratio ranging between 5% and 6% as opposed to the originally proposed threshold of 3%. The specifics of the calculation will ultimately decide how burdensome this mandate is, however, are there are a number of levers regulators could pull to make the rule less onerous (e.g. limit impact of excess reserves).

U.S. Global Systemically Important Banks (G-SIBs)
Bank of America (BAC-NC)
Bank of New York Mellon (BK-NC)
Citigroup (C-NC)
Goldman Sachs (GS-NC)
JP Morgan Chase (JPM-NC)
Morgan Stanley (MS-NC)
State Street (STT-NC)
Wells Fargo (WFC - Neutral, $38PT, Barker)

Source: FSB, Compass Point

Resources

Federal Register notice (PDF)
Community Bank Guide (PDF)
Statement by Chairman Ben S. Bernanke
Statement by Governor Daniel K. Tarullo
Statement by Governor Elizabeth A. Duke
Board Votes

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