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MAJOR SECONDARY MARKET IMPACT SEEN IN S&L CAPITAL RULE

By Sherry L. Harowitz

A new risk-based capital proposal, approved this week by the Federal Home Loan Bank Board, is expected to force many thrifts to restructure their portfolios and it is a safe assumption that the changes will affect thrift participation in the secondary market to a significant degree.

Whether or not that impact will be positive, however, is at this point conjectural.

Importantly, the proposal is designed to bring capital more in line with the riskiness, rather than just the size, of each institution. It would include loans sold with recourse and other off-balance-sheet items in capital calculations.

This could inhibit some securitization activities or--as the Board hopes--lead Wall Street to change the structure of deals so that S&Ls are not liable for future losses from recourse, as they are, for instance, in senior/subordinated deals.

At the same time, secondary market activity may be increased by the low risk weighting given mortgage-backed securities.

The draft is expected to weight Freddie Mac, Fannie Mae and privately-issued MBS at 20 per cent--meaning institutions would only have to hold capital (of six per cent) against one-fifth of the face value of these assets.

The treatment of Ginnie Maes is a little less clear, given differing interpretations from within the Board and no actual draft language at this time.

According to Board Member Roger Martin, GNMAs will be given a zero weight as full faith and credit obligations of the U.S. government--and he says that he intends to introduce language to that effect when the rule is approved for comment by notational vote next week.

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Board Member Larry White, however, says GNMAs will get a 20 per cent risk-weighting, along with other MBS. The reason given by staff for that treatment is that the Board does not wish to distort the marketplace.

This treatment--if adopted--would differ from the approach being taken by the banking regulators, who have given GNMA a 10 per cent ranking compared to a 20 per cent weight for other mortgage securities.

With whole 1-4 family qualifying loans weighted at 50 per cent and other assets, such as commercial loans, junk bonds, and CMO residuals weighted at 100 per cent, the low MBS rating could encourage more secondary market participation.

But the whole loan rating, as well as other features of the proposal, may change before the rule is finalized--and at least one high level Bank Board source believes that such residential loans will get a 25 per cent rating in the end. In that case, the five per cent differential may not be enough to encourage institutions to securitize their portfolios.

Other aspects of the draft rule that could affect the secondary market include an interest rate component and a proposal to place a capital requirement on collateralized borrowing.

With regard to interest rate risk, the Board is proposing to require that institutions maintain capital equal to 50 per cent of the calculated change in an S&L's value that would result from a 200 basis point move in interest rates.

While this might average two per cent of risk assets, there is no upside limit placed on the requirement. To limit the level of capital required under this component, institutions may look to Wall Street for ways to better match the maturity of their assets and liabilities through securitization or hedging.

But the effect of hedging through derivatives is uncertain at this point, because the Board has not yet spoken with regard to what weight it will give mortgage derivatives. It may assign a 100 per cent or higher risk weight to these instruments, but consideration is also being given to assigning a lower risk weight where mortgage derivatives are indeed being used to reduce interest rate risk.

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A proposal to include collateralized borrowings, such as reverse repurchase agreements--put in at the suggestion of Board Member White--may also affect secondary market activity with regard to risk arbitrage activities.

This would significantly raise the cost of risk controlled arbitrage (RCA), a Bank Board staffer confirms. It is particularly significant when viewed in conjunction with another aspect of the draft--the proposal to require consolidation of subsidiaries.

RCA is the purchase of MBS with short-term borrowed funds, such as repos. The purchased MBS are pledged to borrow additional funds, enabling the institution to leverage the original funds many times over. The transactions are generally conducted through subsidiaries, which are not currently consolidated with the parent thrift. Consequently, thrifts avoid both the capital requirements and growth limitation regulations.

But if language proposed by White is ultimately adopted, institutions could have to increase their required capital by three per cent of the pledged assets or collateralized liabilities.

The concern over collateralized borrowings, explains White, is that FSLIC as the senior liability holder is giving up that seniority when assets are pledged and not getting anything in return. Martin appeared to share White's concern, stating that this type of borrowing has increased roughly 955 per cent, compared to deposit growth of roughly 101 per cent over the past several years.

Martin expressed similar concern over thrift investment in collateralized mortgage obligations, which the proposal would weight at 100 per cent. "I equate them to gambling," says Martin.

Darrel W. Dochow, an executive director at the Bank Board, told board members the staff would like to maintain the flexibility during the proposal stage to have residuals placed in a higher category, because their risk is equated with that of derivatives and junk bonds.

In general, the proposal would require six per cent capital for credit risk weighted assets, plus a factor for interest rate risk and special treatment for equity investments. The three components are estimated to equal about eight per cent for thrifts with few direct investments.

The credit risk categories would range from zero to 300 per cent as follows:

- Zero per cent for cash and full faith and credit obligations of the government (including FSLIC notes, but not necessarily including GNMAs, as explained above).

- 20 per cent for state and local general obligations, as well as mortgage-related securities guaranteed by the U.S. government and other high grade private issues.

- 50 per cent for state and local revenue obligations, and one-to-four family qualifying mortgages. Qualifying mortgages will be defined as those with an 80 per cent loan-to-value ratio, including PMI insurance).

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° 100 per cent for commercial and other loans, and possibly for junk bonds and CMO residuals.

° 200 per cent for goodwill and real estate owned.

° 300 per cent for equity risk investments (ERI)--although comments will be solicited on whether it would be more appropriate to subtract ERI from the capital calculations and require a dollar for dollar capital support for such activities.

The dollar for dollar treatment of ERI, which was the staff's proposal, is the equivalent of imposing a risk weight of 1,667 per cent, according to White, who suggested the 300 per cent weighting as a more appropriate level. The staff suggestion was designed to force institutions to conduct ERI through subsidiaries and fund the operations with uninsured deposits, explains a Bank Board source.

Although subsidiaries would generally be consolidated under the proposal, ERI subsidiaries would not be consolidated. As a result, the thrift would only have to provide a dollar for dollar funding of the original contribution to the subsidiary.

Off-balance-sheet items under the proposal would be brought into the calculation of capital relative to the probability that the credit obligation will result from the commitment the institution has made. In general, direct credit subsidiaries--to include recourse loans, guarantees, forward commitments, guarantees and senior/subordinated strips--will get a 100 per cent conversion rate; that is, they will be considered at face value in the calculation of capital, as if they were still on the balance sheet.

This could lead thrifts to reevaluate whether they will create and hold subordinated pieces, notes Former Bank Board Chairman Richard Pratt.

Transaction-related contingencies, and commitments with less certain drawdowns, such as mortgage commitments, will be treated as if 50 per cent of their face value were on the balance sheet. Short-term, self-liquidating, and trade-related contingencies, such as letters of credit backed by a Federal Home Loan Bank, will be put on the balance sheet for capital calculations at a 20 per cent rate. Unconditionally cancellable commitments that are periodically reviewed, such as unused credit card lines, will not be included in the calculations.

In lieu of grandfathering, the Board is proposing a fixed, straight line transition schedule, which would require all institutions to meet 80 per cent of the new requirements by 1991 and to achieve the full capital requirement by 1993, with a two per cent of core capital requirement by 1991. There would also be a special "early intervention" provision to enable the Bank Board to take action against thrifts before they are truly insolvent. It would set a 1.5 per cent of core capital threshold.

(The information contained herein, while obtained from reliable sources, cannot be guaranteed).