

The MSR Reversal: Restoring Traditional Bank Dominance in U.S. Mortgages

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→ **Abstract:** Proposed Fed reforms aim to reverse the post-2008 retreat of traditional banks by removing punitive MSR capital deductions and adopting risk-sensitive LTV weighting

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Section 1: U.S. Mortgage Market

Following the 2008 financial crisis regulators had to enforce new rules on how banks originate and service new loans to the consumers. During that time there were items in the balance which appeared profitable during good times but quickly turned sour during the crisis. Mortgage Service Rights (MSRs) seemed to be one of the main catalysts that deteriorated their balance sheets and imposed serious liquidity risks for these banks. Basel III rules introduced in 2013 were supposed to change this narrative. More specifically if a bank held more than 10% of its safety capital on MSRs then the extra fees being generated had to be deducted from Tier 1 Capital (i.e., its core equity and retained earnings) meaning that less loans would be given out to consumers seeking on buying new homes. In addition to this MSRs hold a punishing 250% risk weighting, which means that banks must hold more capital because of it compared to other assets.

After mandating these rules banks appeared to be safer on paper but this created a problem. Mortgages turned to be

more expensive to be originated and held. Big banks like JPMorgan and Wells Fargo slowly stopped creating new loans and a different power dynamic was established. Before 2013 traditional banks held 60% of mortgages in the market and that gradually changed to 35% in 2023. Non-banks like Rocket Mortgages were involved in origination of new loans. New dangers appear as non-banks lenders don't have safety nets and cannot have a wider reach compared to the established banks. In addition to origination banks are not servicing these loans anymore. In recent trends these US banks sell the loans as soon as they are originated to government sponsored agencies like Fannie Mae and Freddie Mac as well as their MSRs to Rocket because they are deemed as overly expensive to be kept. This whole process means that traditional banks lose a lot of revenues which in turn also diminishes their Return on Equity (ROE) on the mortgage business.

On Monday, February 16th, Michelle Bowman announced that this trend needs to be reversed, and the Fed is ready to make two changes to the rules that

previously caused the problem. She stated that these requirements over estimate risk and make it too costly for banks to engage in the mortgage business. The two changes are going to be on removing the MSR deduction and adapting the risk sensitive weights with the Loan to Value (LTV) approach.

Mae and Freddie Mac banks will be more inclined to originate and service their own loans which benefits the consumer in cases of financial hardship.

Firstly, removing the “hard ceiling” is going to unlock more capital for traditional banks. As stated, before if MSR exceeds 10% of its Tier 1 Capital the excess must be deleted from its books meaning that banks can not originate loans with that money. Usually, a bank lends \$10 for each \$1 it has, and this “restored” capital it will now have will allow banks to use the money which was previously capped. Besides this, banks now will be more inclined to service their loans which in turn means higher returns from MSRs and better client support and relationships for the future.

Another way to boost lending by banks is also to reassess the risk that these loans have. The better tool to do that would be LTV. If a borrower makes a higher initial down payment (i.e., low LTV) the risk that they don't pay is lower compared to someone who does otherwise, so using a “one size fits all” approach seems counterintuitive. By old standards high and low LTV loans were all treated the same and the same risk weight was used for them. The change that the Fed is considering imposing should fix the issue. More specifically depending on the down payment, the money set aside by the bank for the loan should will be different. If the money that needs to be set aside is lower for low-LTV loans that means that the ROE of banks increases which also gives them the option to lower rates for safe borrowers. The result is that, instead of selling the loans to agencies like Fannie

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