FedFin Daily Briefing

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FRB Study Posits an Optimal Capital Ratio, But We Wonder

On Friday, the FRB released a staff paper modelling optimal capital requirements in a dynamic economy to assess the extent to which relatively simple capital rules – e.g., the Basel counter-cyclical capital buffer (see FSM Report **CAPITAL173**) – are sufficient to prevent high-risk yield chasing across the business and financial-market cycle. The paper rejects Basel's GDP-based CCyB in favor of reliance on a simple, but also static capital charge slightly higher than a ten percent risk-based ratio. What types of capital are in this denominator and how all the various components in the current rule fit into this simple ratio are not addressed. Further, many aspects of the paper's modelling leave us to question this conclusion.

For example, the model assumes that banks are funded by deposits and equity derived from households; this leads the model to assume that higher capital leads to less household consumption with adverse output consequences, ignoring large capital holdings by institutional investors and high-wealth households with different marginal propensities to consume. The model also omits significant sources of wholesale funding which may alter key parameters. The paper also states that deposit insurance is funded by taxes, determining an optimal tax rate to enhance the social-welfare benefits of its approach; however, the Deposit Insurance Fund is only indirectly backed by taxes and is instead funded by bank premiums. The paper also focuses only on risk-based capital without considering the interplay between risk-based and leverage ratios and the extent to which this may either mitigate or exacerbate the procyclicality the study seeks to suppress via an optimal risk-based approach.

Although the model is bank-centric, the authors believe its findings can also be applied to nonbanks – an important consideration due to growing concerns about insurance-sector capital requirements under ultra-low rates. However, a key feature of the model rejects the Modigliani-Miller theorem on grounds that deposits are valued for transactional purposes and their costs thus do not drop as an institution's safety increases, an assumption of course inapplicable to nonbanks that may not gather insured deposits.

FRB-NY: Corporate Insolvency Risk Rises Despite Ultra-Low Rates

The Federal Reserve Bank of New York today released an assessment of corporate debt sustainability that paints a grim picture if U.S. growth does not quickly recover or financial-market sentiment for corporate debt shifts back to risk-off. Although the FRB-NY study finds that aggregate debt burdens are sustainable across all large corporate borrowers, several major sectors show acute stress when interest-coverage ratios are compared to EBITDA. Cash-flow shocks generally outpace the benefits of ultra low interest rates to all borrowers, at least as of the end of April. The mining, oil, hospitality, and entertainment companies face particularly challenging odds against maintaining cash flows sufficient to honor their debt obligations. Although utilities and certain other sectors appear

resilient, the study also finds a wide difference among firms. Looking forward, the post suggests that insolvency risk will remain elevated and prove most problematic for companies that were already highly-levered before the pandemic. The post does not assess the impact of recent Fed liquidity facilities on corporate cash flows, but suggests that the enormous wave of refinancing during the second quarter will not fundamentally reduce looming insolvency risk.

Recent Files Available for Downloading

The following reports and analyses have been sent to retainer clients recently. Copies are also available to retainer clients on the Archives section of Federal Financial Analytics' website: www.fedfin.com or clients may obtain the reports/analyses by e-mailing requests@fedfin.com giving the requested item name, firm, and e-mail address. To learn more about GSE Activity Reports, click: http://www.fedfin.com/index.php?option=com_content&view=article&id=18&Itemid=18

- **FEDERALRESERVE58:** Senior Democrats in both the House and Senate have introduced legislation that turns a general call for a "racial-equity mandate" in campaign statements by Vice President Biden into an express directive to conduct monetary, regulatory, payment system, and other policy to reduce racial and ethnic economic disparities.

- **GSE-080420**: Earlier today, we released an in-depth assessment of a little-noticed, but ground-breaking statement released late yesterday by the Federal Financial Institutions Examination Council (FFIEC).

- **COVID12**: The four federal financial regulators along with the CFPB and a state-regulatory representative that comprise the FFIEC have issued new principles designed to guide banking organizations and other lenders through the challenges as forbearance deadlines loom across the spectrum of consumer and commercial loans for financial institutions large and small at a time of fiscal-policy uncertainty.

- **GSE-073120:** When we looked at the GSEs 1Q earnings, we asked if it was "curtains for CRT." The question came then because of the sudden rout in CRT counterparties caused by March's market madness.

- **FAIRLEND7:** The Bureau of Consumer Financial Protection has opened a sweeping inquiry into how credit discrimination occurs and could be averted, seeking comments and suggestions without indicating any possible policy responses

- **CONSUMER35:** As in yesterday's Senate Banking hearing (see Client Report **CONSUMER34**), today's marathon HFSC session with CFPB Director Kraninger was highly contentious.

- **GSE-073020:** Fannie Mae's and Freddie Mac's 2Q earnings statements reveal for the first time that FHFA on June 17 imposed a new liquidity regime akin in some respects to

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the banking agencies' LCR and never-finalized NSFR along with various other liquidity and resiliency standards for GSIBs.

- **CONSUMER34:** As expected, Democrats led by Ranking Member Brown (D-OH) sharply criticized CFPB Director Kraninger at the contentious Senate Banking hearing, citing a lack of enforcement actions and pandemic measures on credit reporting and mortgage forbearance.
- **GSE-072720:** In recent in-depth analyses, we assessed the OCC's new valid-when made doctrine and its latest proposal to define who is deemed a "true lender."
- **PREEMPT34:** As promised by Acting Comptroller Brooks, the OCC has quickly followed up its controversial valid-when-made rule with a proposal defining "true lender" to facilitate the partnerships between banking organizations and other financial companies sometimes called "rent-a-bank" charters.
- **GREEN3:** Building on its 2017 climate-change disclosure work, the FSB issued what it describes as a "stocktake" – i.e., a survey combined with next steps – in this increasingly critical area.
- **GSE-071720:** A new Federal Reserve Bank of New York staff paper sheds timely light on the impact of foreclosure-mitigation efforts on long-term housing markets and household wealth.
- **SBA39:** In this report, we assess the financial policy implications of the wide-ranging House Small Business Committee hearing with Treasury Secretary Mnuchin and SBA Administrator Carranza.
- **MORTGAGE117:** In this report, we assess the HFSC Oversight and Investigations Subcommittee hearing on mortgage servicing.

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