FedFin Daily Briefing

Wednesday, October 14, 2020

Fed Staff Study: Credit-Risk Migration to NBFIs Poses Few Worries

Late last week, the Fed released a staff paper taking on the hot-button question of how much risk results when nonbank financial intermediaries (NBFIs) compete with regulated banks. Noting that NBFI private lending to high-risk, middle-market firms has been the fastest growing market segment, the paper uses a capital regulation/lending model to conclude that bank capital levels improve lending standards because nonbanks compete with banks but do not do so by taking more risk than banks unless bank capital charges are well above current levels. This conclusion does not in our view square with the fact that much of this market is served by nonbanks and much analysis – see the IMF's financial-risk forecast yesterday, the Fed's most recent financial stability report, and new Fed-rescue facilities – may suggest otherwise.

The rationale here, which the paper readily admits is counter-intuitive, is that high capital standards reduce bank deposit-insurance funding advantages, allowing nonbanks to compete against banks without taking more risk than banks. In essence, banks use private information to judge credit quality and nonbanks rely on collateral, but nonbanks are said properly to judge collateral risk or at least to do so no less well than banks are able to assess private information. Only when capital standards drive banks out of markets does risk increase, but even then not to problematic levels because, the paper posits, nonbanks are as good as banks at identifying loans with sound, risk-reducing collateral. In essence, according to this paper's model, nonbanks substitute for banks when bank capital requirements create incentives for banks not to use private information to underwrite loans that still have sufficient collateral on which nonbanks base their credit decisions. The paper notes that nonbanks might compete in markets without sound collateral but says it "does not happen" in their framework; the extent to which it has occurred in real life is left unaddressed. Despite its sanguine assumptions about nonbanks, the paper also constructs a model for assigning market-based capital to nonbanks regardless of form or function (e.g., MMFs versus insurance companies versus finance companies, and so forth); a new, "optimal" macroprudential framework for banks in line with the proposed nonbank construct is also proposed.

SF Fed: Fed Policy Makes America More Equal

In a speech late yesterday, San Francisco Fed President Daly took a dramatically different tone than usual from the Fed on its ability to influence economic inequality. Although Chairs Bernanke, Yellen, and now Powell attribute economic inequality principally to fiscal policy, Ms. Daly suggests that post-2008 Fed policy played a vital role in the what she describes as equality improvements after 2010. Looking ahead, Ms. Daly cites the Fed's new "make-up" policy as a critical equality engine, in contrast also with other Reserve Bank presidents at an event last week who said that the Fed's inequality impact will come largely through new research. Ms. Daly did, however, note some limitations on Fed inequality impact, calling for infrastructure spending and other stimulus measures to address ongoing inequality and COVID's adverse impact on it.

FSB Continues Low-Level Work on Market Fragmentation

Continuing a series of reports to the G20, the FSB today detailed ongoing work to address market fragmentation. Little in it is new, with the FSB reiterating ongoing actions such as its TBTF consultation (see FSM Report **TBTF23**), but the report today does reinforce ongoing negotiations designed to reduce ring-fencing. Work thus continues on how to identify unallocated internal TLAC (see FSM Report **TLAC7**) to provide technical guidance to cross-border resolution authorities. Research also continues on the extent to which the COVID crisis has accelerated market fragmentation and how these measures could be unwound without fragmentation effects.

FOMC Proposes Technical Changes to FOIA Procedures

The FOMC today proposed what it describes as technical changes to its rules governing FOIA procedures. These would implement non-substantive updates to make the FOMC's FOIA procedures consistent with current practice, incorporating recent changes in both law and guidance. They also incorporate formatting- and language-related changes to the FRB's FOIA procedures effective tomorrow. Comments are due 60 days after *Federal Register* publication.

Quarles: Year-End Release of Bank-Specific CCAR Results, NBFI Review is Wide, Slow-Go

FRB Vice Chair for Supervision Quarles today defended the FRB's decision to suspend stock repurchases and limit dividends through the fourth quarter, arguing that economic uncertainty combined with widely-varied bank outcomes require capital preservation. However, countering one source of criticism, the vice chairman said also that bank-specific results will be released before the end of the year, disclosures with considerable impact on Fed forward capital-distribution policy and bank strategy. Mr. Quarles also provided an update on the FSB's NBFI vulnerabilities, confirming its focus on MMFs, dealer capacity and willingness to intermediate, core government-bond markets structure in light of leveraged investors, and U.S. dollar cross-border funding fragility. While the FSB's holistic review of the COVID event is due next month, the FSB is not yet prepared to hold any of these factors responsible for March market turmoil. Instead, the review will include a set of proposals for follow-up work on NBFI that will form the basis of a 2021 workplan focused on better understanding the sector, its vulnerabilities, and macroprudential options.

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

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- **CRA30**: Following opposition to the OCC's CRA rewrite, the FRB has proposed an initial construct that takes some elements of the OCC's approach and adds further and in some cases different provisions to craft what the Fed hopes will become an inter-agency CRA construct in 2021.

- **BIGTECH**: Last week, the House Judiciary Antitrust Subcommittee released a lengthy, high-impact Democratic report calling for structural changes to the nation's biggest tech-platform companies.

- **GSE-100820:** As will soon be detailed in an our in-depth report, the Federal Reserve's long-awaited CRA proposal is a comprehensive rewrite that, while preliminary, would dramatically change large bank community-focused lending and investing.

- **CORPGOV31**: In this report, we analyze the strategic implications of enforcement actions against Citibank issued late yesterday by the Fed and OCC.

- **CAPITAL226**: In conjunction with numerous changes to its supervisory stress test (CCAR) for the largest U.S. banking organizations in response to COVID, the Federal Reserve is seeking comment on structural changes to current capital-planning requirements.

- **GSE-100120**: A troubling new IMF staff paper looks at U.S. housing policy since COVID to uncover some worrisome aggregate and distributional effects.

- **CRYPTO15**: Continuing Acting Comptroller Brooks' efforts to enhance innovation at national banks and federal savings associations, the agency has now authorized these institutions to hold reserves associated with certain stablecoin offerings.

- **GSE-092820**: Following its morning meeting, FSOC late Friday released the staff statement expressing its near-term decision on systemic risk in the secondary mortgage market.

- **AML132**: FinCEN is beginning a process that, while apparently not revising or eliminating any existing anti-money laundering (AML) requirements, would add an over-arching principle that AML programs be efficient, "reasonably-designed," and capable of providing high-quality information to law enforcement and other government entities.

- **COVID15**: HFSC's second CARES Act-required hearing with Treasury Secretary Mnuchin and FRB Chair Powell continued to stress the theme that has become apparent ever since negotiations on a Phase IV relief bill stalled: Democrats primarily want additional direct fiscal support and Republicans are pushing for adjustments to existing relief programs funded by unused 13(3) Treasury backstops.

- **GSE-092220**: As usual, FHFA's new strategic plan is more rhetorical than real. Still, it has a noteworthy emphasis on ending the conservatorship, promulgating new standards, and enhancing inclusion not just at the GSEs and within FHFA, but also in credit access.

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- **CRA29**: Emphasizing its new focus on racial equity ahead of several Congressional hearings this week, the Federal Reserve Board today unanimously approved a long-awaited ANPR revising its CRA regulations.

- **GSE-092120**: Late last week, the Federal Reserve Bank of New York announced that the Fed bought almost $56 billion in agency MBS over the past two weeks.

- **GSE-091720**: As anticipated, today's marathon HFSC hearing with FHFA Director Calabria covered a wide-range of issues we will shortly analyze in detail due to the policy and strategic importance of several exchanges.

- **FAIRLEND8**: HUD has largely finalized a controversial fair-housing rule as proposed, with the new standards for adjudicating fair-housing disputes giving defendants numerous additional protections.

- **GSE-091020**: As we noted yesterday in our in-depth analysis, a CFTC subcommittee has issued a landmark report laying out an array of climate-change risks it urges policy-makers to prioritize to prevent systemic and sector risks.

- **COVID14**: Today's Senate Banking hearing on the status of emergency Fed facilities showed even more clearly the dividing lines between Democrats and Republicans on changes to the Main Street Lending program than the CARES Act Congressional Oversight Commission's recent hearing.

- **GREEN4**: In this report, we analyze an influential and possibly even game-changing paper released today by the CFTC's Climate-Related Market Risk Subcommittee.

- **GSE-090320**: As noted in our three summaries of key FHFA comment letters, FHFA was not exactly overwhelmed by heartfelt praise for its GSE capital rule.

- **COVID13.pdf**: As anticipated, today's House Select Subcommittee on the Coronavirus Crisis hearing with Treasury Secretary Mnuchin reflected contentious negotiations over a phase four rescue package.

- **GSE-090120:** In this analysis, we continue our assessment of comment letters to FHFA on the capital proposal.

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