FedFin Daily Briefing

Monday, December 28, 2020

BIS: Lower for Longer Makes Syndicated Lending Even Riskier

As lower goes from longer to seemingly forever, BIS staff have released a new paper showing not only that ultra-low rates induce bank risk-chasing, but also that this risk-taking is not – as prior research suggested – largely limited to better-capitalized banks. Instead, banks with low market capitalization are also found to be higher risk-takers under low rates, with low U.S. interest rates having an over-arching impact on global-bank risk-taking. The most likely risk-takers in this sector are banks with high regulatory capital and low market capitalization.

The paper concludes that the incentive for highly-capitalized banks to take risk in this sector is lower probability of supervisory actions; that for banks with low market-cap is less shareholder "skin in the game." The paper does not go on to assess the safety-and-soundness and even systemic impact of low market capitalization as Lawrence Summers did when positing trade-offs between tough standards and market resilience. Instead, its focus is on the unintended impact of monetary policy on risk-taking and what it calls previously-unrecognized spillovers of Fed action across the global financial system. The study also finds that the link between lower rates and higher risks significantly strengthened after 2008 (up eighty percent in the U.S. and double in the EU).

The paper analyzes syndicated loans to nonfinancial firms in which a bank is the lead arranger from 1983 to 2019. It assumes that it captures only loans from banks subject to regulatory-capital standards, but expressly notes that it deems these to include "U.S. investment banks." Loans are defined by the paper to mean those from lenders classified as deposit-taking institutions under the NAICS or as banks under the Thomson Reuters (Refinitiv) Business Classification, but the paper does not make clear which of these classifications is actually deployed. Some in fact capture investment banks outside the Fed's reach and thus not subject to regulatory-capital standards. Assuming application of capital rules to these companies would significantly distort the study's findings if the classification is problematic and unregulated companies are a large portion of the U.S. sample.

FHFA Begins Action on Appraisal Discrimination and Modernizations

Presaging a possible directive to the GSEs, FHFA today requested comment on current appraisal policies, discrimination risk, and potential modernizations. Reflecting what FedFin has called the new, "racial-equity era of consumer finance" (see Client Report **CONSUMER36**), FHFA seeks views on research substantiating valuation differences by borrower and neighborhood ethnic makeup, the extent of any disparities, and what might be done about them. FHFA also asks if there is discrimination in current collateral valuation practices and if alternative or automated methods would have a discriminatory impact.

Views are also sought on whether new valuation solutions are needed to address limited appraiser capacity and what these might be. FHFA also asks about non-traditional valuation services such as inspection- or exterior-only valuation that might augment traditional appraisals, the potential for appraisal waivers, alternative inspection workforces, potential risks, data available to appraisers without crowding out other data providers, how to improve collateral tools, and the potential for lenders to manipulate automated underwriting systems. Comment is due February 26.

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 info@fedfin.com giving the requested item name, firm, and e-mail address. To learn more about *GSE Activity Reports*, click here.

- **GSE-122820**: As we noted last week, FHFA is barreling through the systemic rulebook, finalizing capital rules, proposing liquidity standards, and, now, laying out living-will requirements to ensure orderly GSE resolution under even acute stress.
- **CRYPTO16:** Late Wednesday, the President's Working Group on Financial Markets (PWG) issued yet another unprecedented U.S. policy statement, following one on MMF reform just the day before with a statement from Treasury, the FRB, SEC, and CFTC on U.S. stablecoin policy.
- **MMF16**: Late yesterday, the President's Working Group on Financial Markets (PWG) issued an unusual report signaling agreement by Treasury and the FRB, SEC, and CFTC on the urgent need for changes in the MMF sector to prevent systemic "dash-for-cash" events such as the most recent March crisis.
- **GSE-122320:** It's beginning to look a lot like a major policy theme: research continues to show that GSE mortgages cost Black and Hispanic borrowers considerably more than non-Hispanic whites, especially over the course of a loan, not just at origination.
- **FEDERALRESERVE59**: It's hard to envision a Federal Reserve still more central to every aspect of U.S. macroeconomic, financial, and fiscal policy, but that's what FedFin forecasts for 2021.
- **ILC15:** Setting the stage for new charters and legislative battles in 2021, the FDIC has finalized a controversial proposal addressing source-of-support and certain other obligations for the parent companies of some industrial banks and industrial loan companies (ILCs).
- **GSE122120:** As previously noted, FHFA late last week issued a long-promised proposal implementing LCR- and NSFR-like – but not light – rules for Fannie Mae and Freddie Mac.
- **CONSUMER36**: On Monday, the Biden transition released a readout of a meeting between Treasury nominees Janet Yellen and Wally Adeyemo with various racial-equity associations, reinforcing the importance this issue will have in crafting financial regulation in the Biden Administration.
- **GSE121720**: FHFA's controversial capital rule is in today's *Federal Register*, setting an effective date of February 16.
- **GSE-121620**: Secretary Mnuchin's comments yesterday make it clear – at least mostly – that Fannie and Freddie will remain in conservatorship as the Biden Administration takes charge.

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- **REFORM200**: In this report, we continue our 2021 forecasts, moving from our assessment of digital finance (see Client Report **DIGITAL6**) and asset-management regulation (see Client Report **RECOURSE6**) to an assessment of the U.S. capital and liquidity framework for large banks and FBOs.

- **RECOURSE6**: In this report, we assess the regulatory consequences of one of the ironies of March's market turmoil: among the reasons it was not worse is because some large banks stepped in and backed customers or investors despite the lack of any legal obligation to do so.

- **CHARTER28:** Continuing Acting Comptroller Brooks' policy of considering precedent-breaking applications and charters, the agency has received a controversial application from Figure to establish a national bank that, by virtue of this charter, would also be a Fed member.

- **GSE-120720:** The last Trump FSOC annual report reiterates 2019's findings: nonbank originators and servicers are weak and interconnected, thus posing systemic risk.

- **DIGITAL6:** Even though 2020 was of course preoccupied by the pandemic, there was no scarcity of the oft-repeated nostrum that law and rule must define the future of digital finance.

- **CHARTER27**: In conjunction with a wide-open request for views on ways to increase the innovativeness of national banks and federal savings associations (FSAs), the OCC has finalized a significant rewrite of their more traditional powers and activities.

- **GSE-120220**: Today's House Financial Services session with Mnuchin and Powell shed just a bit more light – or provided still more uncertainty – on the critical question of whether Treasury will work with FHFA to end the conservatorships before the Biden Administration surely keeps them for a long, long time.

- **GSE-120120A**: At today's Senate Banking hearing on the CARES-funding fracas, Secretary Mnuchin told Sen. Rounds (R-SD) that the GSEs should be quickly brought out of conservatorship but that they will not be let out without sufficient capital.

- **GSE-120120**: Given the high confirmation odds for Janet Yellen as the nation's next Treasury Secretary, we here assess her impact on the future of U.S. housing finance.

- **ESG3**: Following through on one of his pledges, Acting Comptroller Brooks' agency has issued a controversial proposal to prevent large banks and perhaps all federally-chartered ones from deciding whether or not to grant credit on grounds other than clear, quantitative indicators of ability to repay.

- **GSE-112420**: Building on our analysis of the overall final FHFA capital rule, we turn here to an assessment of the rule's strategic impact.

- **GREEN5**: In its latest report on climate risk, the Financial Stability Board reiterates the complexity of measuring financial-system climate risk, continuing its work to enhance the ability of regulators and financial institutions to do so due to the magnitude both physical and transition risks are likely to pose.

- **GSE-112320:** In this report, we build on our initial summary of FHFA's final capital construct to assess one of the most important issues on which FHFA made at least some concessions.

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