FedFin Daily Briefing

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Fed Study: Local Lenders Vital to Small Business

In a new FRB staff paper, researchers find that technology advances have not altered the fundamental dependence of small businesses on local banks. Indeed, community banks remain critical not only to credit availability in this sector, but also to the riskier credits most directly responsible for employment gains. Technology advances such as small-business credit scoring are found to be feasible only for large-volume lenders, while collateral valuation is almost always done at a very local level. Small businesses also have a strong preference for local lenders from whom they receive bundled services apart from credit. Using over twenty years of CRA data, the Fed study breaks down the aggregate results in prior work to look at different types of lenders and borrowers. Although the data show pre-recession increases in longer-distance lending suggesting the benefit of technology improvements, this turns out to be because longer-distance lenders (largely eighteen specialty companies) took on a greater share of small-business lending. In fact, by the end of the study, these longer-distance lenders went from a market share of three percent to thirteen percent. Technological change's information efficiencies thus appear to have benefited large lenders, not small businesses. As a result, small-business lending is increasingly dependent on larger loans from less competitive lenders, making it still more important for small businesses to have local lending options. The paper notes, however, that confirming its conclusion requires more research on information asymmetries in the small-business credit market and data outside the CRA base. We note for example that CRA data do not capture the significant role of online marketplace lending over the past few years, although some studies show potential market segmentation or even discrimination. A forthcoming FedFin issue brief will assess the prospects for CRA expansion to nonbank lenders, including those in the small-business market.

Brainard Rebuts Democratic Demands for Climate Stress Tests

FRB Gov. Brainard today strongly reiterated prior comments emphasizing the hazards of climate risk to banking organizations, also detailing the Fed's growing effort to mitigate it. Importantly, Gov. Brainard rebutted calls from Democrats for mandatory stress testing or prescriptive risk-mitigation standards, laying out hazards in areas such as model building and scenario analysis. The physical and transition risks she outlined track those in a recent in-depth CFTC report (see Client Report **GREEN4**), going on to discuss the various efforts under way at the Fed recently detailed in a Federal Reserve Bank of San Francisco report and the Fed's recent actions. Consistent with prior Fed statements, Gov. Brainard did not call for climate stress testing, instead laying out both the need to do so over time and remaining data and conceptual problems. "Standardized, reliable, and mandatory" disclosures are also essential but nonetheless remain a ways off. Nonetheless, Gov. Brainard said that these uncertainties should not slow financial-risk mitigation, noting the need to develop both risk-management and supervisory tools appropriate to both the magnitude of climate risk and the challenges in measuring and forecasting it.

FRB-NY Finds Repo Market to Be Competitive, Transparent

Using confidential data, the Federal Reserve Bank of New York's blog today includes a post rebutting BIS assertions that the U.S. repo market is unduly concentrated in the hands of just four banks. This conclusion is important not only for analytical accuracy, but also as a policy guide. As previously noted (see *Client Report* **TMARKET**), repo reform is a top priority for Treasury, the Fed, and global regulators. Findings are also said to support the use of SOFR as a LIBOR replacement because they demonstrate that repos are a competitively-priced marketplace. However, pricing in the dealer/client market remains opaque, warranting additional transparency.

Looking at every day in the repo markets during 2020 across an array of repo instruments and on both sides of the transaction, the post finds that large participants do not concentrate the inter-dealer market, with the largest five entities accounting for about half of total activity and the top ten holding no more than 64 percent. These percentages roughly hold also for the centrally-cleared segments of the repo market, with sponsored trades actually reducing concentration despite assertions to the contrary. Tri-party repos are also found not to be concentrated. GCF trades do show some concentration (almost eighty percent for the top five), but this is a considerably smaller market and thus unsurprising to the post's authors.

Senate Banking: Brown, Toomey Talk COVID Response, Equity

Today's Senate Banking hearing focused on ensuring an equitable recovery from the pandemic without discussion of financial policy. In his opening statement, Chairman Brown (D-OH) emphasized the need for Congress to work for all Americans, particularly those disproportionally affected by the pandemic. Ranking Member Toomey (R-PA) blasted the American Rescue Plan (ARP) as a partisan, wasteful, un-targeted bill without any real economic justification. Other senators echoed these themes along party lines.

Fed Finally Eases Netting Eligibility

The FRB today released a long-awaited final rule expanding eligible netting institutions to those meeting new standards determined on both qualitative and quantitative criteria. Companies that hold themselves out as market intermediaries and have outstanding derivatives exposures over a notional $1 billion level and meet other trading levels may now count on netting protections. Newly-eligible entities must also fall into an expanded list of eligible entities that now includes large swap-clearing and derivatives-clearing entities, designated financial market utilities, foreign banks, foreign central banks, Federal Reserve Banks, and the BIS. Any designated nonbank SIFIs and qualifying CCPs would also be eligible, with all of these changes reflecting the Board's decision that regulation has significantly improved since 1991, warranting this added protection. The final rule does not apply to foreign GSIBs and several other entities that sought it, although the final rule notes that case-by-case eligibility remains an option. The rule is effective thirty days after publication in the *Federal Register*.

HFSC Turns Trading Focus from Generic Wall-Street "Rigging" to Brokerage Practices

HFSC today held the first in a series of hearings examining recent market volatility related to GameStop and Robinhood. Despite initially-blistering statements from Chairwoman Waters (D-CA) and progressive Democrats, the session only laid out initial concerns and data demands. Chairwoman Waters said the incident shed light on potential conflicts of interest, the "predatory" ways in which certain funds operate, social media's ability to influence markets, and gamification issues, contending that it reinforced the belief of average Americans that the financial system is stacked against them in favor of "Wall Street." She also highlighted that the purchase of order-flow data limits market transparency, noting forcefully that Dodd-Frank required rulemakings on short-selling disclosures were never implemented. Capital Markets Subcommittee Chairman Sherman (D-CA) also said a review of policies related to payment for order-flow is needed along with accelerated trade-settlement timing.

Ranking Member McHenry (R-NC) led Republicans pushing back against the need to increase retail investor protections, saying that "meme mania" shows that retail investors are more sophisticated than most policymakers believe. Rep. McHenry argued that Congress cannot turn back the clock and should look to level the playing field between retail and institutional investors through changes such as a lower accredited-investor threshold.

Prior to HFSC's hearing, Sen. Warren (D-MA) released a letter to Citadel Securities arguing that that the payment-for-order-flow model raises inherent conflicts of interest with no actual relationship to underlying equity values. While the letter does not call for any specific policy changes, it asks a series of questions regarding Citadel's financial relationship with Robinhood, the mechanism by which it and affiliated entities profited from GameStop trades on Robinhood, information regarding its investment with Melvin Capital, and whether any Citadel or affiliated personnel were involved in the decision by Robinhood to restrict trading. A response is requested by February 22, by which time Senate Banking Chairman Brown (D-OH) will likely have announced his own hearing into this issue.

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.

- **REALESTATE24:** Continuing the OCC's recent actions to expand national-bank powers into unprecedented arenas, the OCC has now proposed major liberalization of the ways in which federally-chartered organizations may use commercial real estate owned as bank premises.
- **GSE-020121:** While it will take time for the swamped Biden Administration to craft U.S. housing policy, elements of it emerged last week during stimulus negotiations, the President's statement, and HUD-nominee Fudge's appearance before Senate Banking.
- **CAPITAL227:** Although the FRB in its proposal indicated that this rulemaking would also begin consideration of the U.S. large-bank capital framework post-COVID, its final rule largely confines itself to aligning stress-test standards with the 2019 tailoring rule and stress capital buffer (SCB) for Category IV banking organizations.
- **GSE-012221:** The failure of yet another Administration and Congress to conquer the conservatorships does not augur well for constructive policy action anytime soon.
- **INVESTOR14**: In this report, we expand on prior forecasts to assess broad financial-regulatory and structure issues under the SEC's jurisdiction under what seems likely: a Chairman Gensler. His will be an activist SEC, one sure to throw broker-dealers, asset managers, and investment funds from the relative comfort of the last four years.
- **GSE-012121**: As forecast following a landmark CFTC-committee report and the Fed's financial-stability assessment, FHFA has now turned to the climate risk that worries them the most: residential real estate.
- **GSE-011521:** Last night, Treasury and FHFA announced an agreement on the GSEs' conservatorship unsatisfactory to all concerned and highly objectionable to many of those on the Hill with the power to change it.
- **GSE-011321:** Setting Senate Banking's agenda yesterday, incoming Chairman Brown highlighted refi inequality as a top committee priority.

- **CRYPTO17:** This interpretive letter (IL) follows an OCC advance notice of proposed rulemaking that suggested a notice-and-comment process before the agency made substantive changes to the digital-currency powers of federally-chartered banks.

- **AML133:** In a cliff-hanger before the end of the 116th Congress, the National Defense Authorization Act was enacted into law with an array of provisions significantly revising U.S. anti-money laundering (AML) and countering the financing of terrorism (CFT) requirements.

- **ELECTION25**: It will take considerable time for Congress to absorb the meaning of yesterday's insurrection not only in institutional terms, but also and more immediately with regard to each Member's thinking about his or her own policy and political agenda.

- **TMARKET**: As we noted earlier (see *Client Report* **REFORM200**), we do not expect U.S. regulators to extend SLR relief (see FSM Report **LEVERAGE23**) after its scheduled March expiration.

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