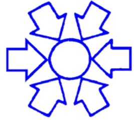
Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: January 29, 2021

Although little-noticed, the Biden Administration's new, public-good regulatory paradigm is a game-changer. I've laid out "should-do" arguments in a memo/op-ed and a how-to in a new blog post. Some of you have countered with reasonable fears of over-reach and regulatory burden and it will indeed be critical to make clear that crippled companies can do no good. However, even if this new regulatory construct is a bit more burdensome, it has considerable upside for financial-services firms. Below, an example based on capital regulation to show both why and how.

As we've noted, federal banking agencies plan this year finally to turn to implementing the 2017 "Basel IV" package. Included in it is a new standardized approach (SA) capital framework resetting the rules that bind even the biggest U.S. banks. Thinking through the public-good implications of this rewrite along with the usual direct cost and competitiveness consequences illuminates opportunities to serve unmet market needs, offer new products, and even address racial equity.

In fact, once one starts to think about capital rules as tools not only for bank safety, but also for macroeconomic purpose, it becomes clear that the SA could be reconfigured to make a meaningful equality difference without added risk. For example, equality-essential lending categories such as small-dollar loans, small-business loans, and small-balance mortgages are ill-treated in the current capital construct. With the exception of an upper $1 million threshold on preferential small-business weightings, the risk-based capital rules treat small-balance loans the same as jumbo or highly-leveraged obligations. This simplicity absolves banks – not to mention regulators – of burden, but it throws up formidable barriers to profitable products for lower-income borrowers.

There are several ways to right this wrong without new risk. First, low-risk loans – e.g., those for home purchase – can be differentiated from higher-risk refinancings, second homes, or rental properties. Some of the rules sort-of do so, but none does it well and lower-income and first-time borrowers are worse for it. In small-business lending, small-business revolving credit could be set apart from riskier start-up loans and given the capital advantage they actually deserve. Small-dollar loans structured to protect repayment could be advantaged over installment loans that aren't, and so forth. Current capital rules assume that small loans to those with little credit history or scant resources are by definition risky; in fact, they often aren't.

Instead of and even in addition to new risk weightings, classes of loans with demonstrable public-good benefits could also receive capital discounts up to certain exposure amounts. This might

2101 L Street, N.W. – Suite 300
Washington, DC 20037
Phone: 202.589.0880

E-mail: info@fedfin.com
Website: www.fedfin.com

sound a bit closer to credit allocation, but it's not the least bit unprecedented – for example, banks get a capital discount on certain derivatives exposures up to portfolio thresholds and similar benefits accrue to mortgage servicing assets below an exposure ceiling. Why not do the same for high-LTV low-balance mortgages or start-up small business loans, giving banks incentives to create portfolios that benefit not only from a capital discount, but also risk diversification that earns it?

And, what about public-welfare investments – investment banks are now allowed to make in low-income communities as long as banks don't make too many of them? Compared to much else that banks do, the risks of public-welfare investments seem more than manageable. Adding in explicit community-development obligations that insulate public-welfare investment from conflicts of interest provides a meaningful barrier to commercial activities and yet could offer significant public benefit. If the risk of transgressing commercial barriers is too great, fine – leave current portfolio limits in place, but give public-welfare investments a capital benefit along the lines outlined above for other public-good undertakings.

In addition to new capital weightings for old products, new products should get new weightings. One product worth renewed consideration is covered bonds. These centuries-old features of the European financial system are financial instruments in which a bank retains assets – mostly mortgages – on its balance sheet but sells the credit risk to third-party investors. With a huge securitization market, the U.S. never developed covered bonds and, when thought turned to them, the FDIC shut it down, fearful of adverse selection in the loans banks kept versus those placed into covered bonds that would disadvantage the Deposit Insurance Fund. This is indeed a risk, but one that can now be far better controlled through risk tranching that aligns a bank issuing covered bonds with the FDIC's interest. For extra protection, covered bonds could also be subject to portfolio limits (see above).

What if banks constructed bonds comprised of low-balance mortgages, small-business loans, public-welfare exposures, or other obligations with demonstrable public good when the loans are affordable and sustainable? There's a $1.2 trillion market for leveraged credit running after yield. Wouldn't investors do better by purchasing covered bonds comprised of targeted loans, with banks given an extra incentive to construct these obligations by receiving the capital credit they deserve for transferring most of the credit risk? What a great ESG market this would make!

These ideas may seem as if they're off the top of my head, but a good deal of research lies behind them. And, of course, the new SA isn't the only rule heading at the financial system in 2021. Structural reforms to MMFs are a top priority that might seem far afield from economic equality and racial equity, but there are ways to rethink even more abstruse requirements once one adds public-good considerations to traditional thinking about private wealth. Over the years, I've read and even written a lot of comment letters touting public benefit; now, it's time to create and prove it.