FedFin Daily Briefing

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FRB-NY Climate Stress Test Reveals Large Capital Shortfalls

A new Federal Reserve Bank of New York paper proposes a climate stress-test methodology which, when deployed, finds significant systemic risk due to large bank capital shortfalls during periods of sharp transition risk. This will likely spur Congressional advocates pressing not only for mandatory climate stress testing (see FSM Report **GREEN9**), but also capital-related charges (see FSM Report **GREEN10**). The methodology is based on public data and said to be readily computed under even volatile circumstances. It includes a "CRISK" measure of a financial institutions' capital shortfall under stress scenarios using stranded asset portfolio return to assess transition risk and the dynamic conditional beta model along with institution-specific measures (e.g., leverage). Twenty-seven global banks with large fossil-fuel exposures are then put through this process, which finds significant correlation across all surveyed banks during the energy-price drop in 2020. Several banks were also exposed to "economically substantial" capital shortfalls. For example, Citigroup had a climate-driven shortfall of as much as $125 billion, a surprising contrast to very small shortfalls at Canadian banks despite greater fossil-fuel exposures. The differences are said to relate to how Canadian banks manage their transition-risk exposures along with other bank-specific differences. Although this contrast suggests some methodological challenges at least with regard to public estimation of varying capital shortfalls, the study's overall findings for these banks lead to a conclusion that sharp transition risks could lead to capital shortfalls of systemic proportions. The researchers plan next to adapt their methodology to assess physical climate risk and loan concentrations in areas at high risk to floods or similar events. Using alternative data to assess shortfalls is said also to be fruitful.

Timeline Set for GSE Capital Rewrite

The *Federal Register* today includes FHFA's proposed changes to the GSEs capital framework. As detailed in our in-depth report, the rule would actively promote CRT and rewrite the leverage ratio, making risk-based capital the GSEs' binding constraint. The rule does not impose any limits on the types of CRT GSEs could select, also withdrawing the "effectiveness" test in current rules. Comment is now due November 26.

Gensler Ramps Predictive-Analytics Threat Up to Systemic Risk

Following his Senate Banking appearance earlier this month (see Client Report **INVESTOR18**), SEC Chairman Gensler today reiterated his focus on digital engagement practices (DEPs), warning that predictive data analytics could increase systemic risk due to increased data- source concentration, herding, and interconnectedness. We continue to expect FSOC discussion of these issues in its 2021 annual report but little action on them outside any undertaken expressly by the SEC until the Council has finished work on various Presidential orders, stablecoins, MMFs, and the other complex but high-priority items on its agenda. Again highlighting potential conflicts of interest, Mr. Gensler also stated that that robo- and investment-advisers may be using DEPs to maximize platform revenues, data collection, and customer engagement, not investor return. He also reiterated concerns about fair pricing, also emphasizing the need to clarify what qualifies as a recommendation versus investment advice. The SEC late last month issued an RFI on the use of DEPs; comments are due October 1.

McHenry Attacks Treasury for "Social Agenda," Warns of Chinese Threat

Ahead of Treasury Secretary Yellen's appearance before HFSC this Thursday, Ranking Member McHenry (R-PA) blasted Biden administration financial policy on grounds that it advantages China at cost to U.S. national interest. Specifically, he said that the U.S. is now is using the IMF and the World Bank to "virtue signal" social agendas, pushing borrowers to Chinese banks. He warned that China's attempts to increase its influence and its "predatory lending" through Belt and Road jeopardizes the ability of the IMF and World Bank to assess financial risk. He also criticized last month's Treasury MDB fossil fuel guidance, suggesting that this move only encourages other countries to seek financing from China. The SEC also comes in for blame, with Rep. McHenry attacking Chairman Gensler for mandating climate disclosures, arguing that using securities regulations to impose "social agendas" undermines U.S. credibility. Although he emphasized the importance of the dollar's supremacy, he made no mention of CBDC despite bipartisan worries about competitiveness with China if the Fed does not accelerate its CBDC efforts (see Client Report **CBDC4**).

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-092421**: According to a group of Senate Democrats, the answer to this question for a new class of federally-backed mortgages is "out of debt."
- **GSE-092221:** Getting a bit ahead of FHFA's new equitable-finance mandate and its express demand for appraisal equity, Freddie Mac has released a detailed study of one of the most significant barriers to housing-finance equity: discriminatory appraisal practices that reduce the chances for wealth accumulation.
- **DATA2**: Today's HFSC Fintech Task Force Hearing featured an appearance by Full Committee Chairwoman Waters (D-CA) arguing against consumer opt-out.
- **PUSH-OUT14:** As we noted, SEC Chairman Gensler's written Senate Banking testimony included a short – but very significant – statement prioritizing Commission review of key fixed-income market sectors.
- **GSE-091621**: As we noted, FHFA wasted no time after the PSPA revision with its proposed changes to GSE capital regulation.
- **GSE-091521**: As noted yesterday, Treasury and the FHFA pulled the Trump PSPA's plug, although importantly and widely overlooked is that this is true only when it comes to near-term asset-purchase considerations.
- **INVESTOR18**: As is often the case, Senate Banking's hearing today with SEC Chairman Gensler did not touch on the fixed-income structure questions highlighted in his written testimony even though these could be among the most consequential for long-term capital-market regulation and the balance between the Fed and SEC in this key arena.

- **GSE-091021**: Soaring house prices have of course aroused lofty housing-bubble worries.

- **GSE-090821**: As Karen Petrou's Monday memo forecast, FHFA is doubling down on an already-ambitious work plan to make Fannie and Freddie the epitome of mortgage-finance equity.

- **SMBUS27**: Turning again to a provision in the 2010 Dodd-Frank Act, the Bureau of Consumer Financial Protection has issued a sweeping proposal to implement small-business and small-farm lending disclosure requirements akin to those long required under the Home Mortgage Disclosure Act (HMDA).

- **GSE-090121**: A major paper delivered at last week's Jackson Hole Fed meeting shows – we think conclusively – that it's not demographics that keep interest rates so, so low, but wealth inequality.

- **OVERDRAFT10**: Senior Senate Democrats have proposed legislation that would sharply restrict most transaction-account overdraft fees to the point of likely eliminating them for most consumers at most depository institutions.

- **GREEN10**: House Democrats are considering legislation to mandate a punitive capital construct for bank and, in some cases, also to certain nonbank exposures to companies with fossil-fuel links.

- **GREEN9**: Legislation from House and Senate Democrats would force the Federal Reserve quickly to implement mandatory stress testing for all large banking organizations and large nonbanks judged by asset size if they are principally engaged in finance.

- **GSE-090121**: A major paper delivered at last week's Jackson Hole Fed meeting shows – we think conclusively – that it's not demographics that keep interest rates so, so low, but wealth inequality.

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