Thursday, December 2, 2021

Fed Staff Assess Big-Bank Correlated Risk, Systemic Hazard

A new research note from the Federal Reserve looks at a critical question: how correlated have bank exposures become in the wake of stress testing and other rules many analysts, ourselves included, anticipated. To the extent exposures are correlated, systemic risk is likely to increase, especially if correlations are tightest at the biggest banks and/or correlated exposures are risky. This paper updates prior research with both an expanded bank sample (those with assets over $10 billion) and post-2020 data, finding greater correlation across all of these BHCs since March of 2020. Prior to 2020, the biggest BHCs (those with assets over $250 billion) had the most correlated exposures; now, this correlation is considerably greater due to the sharp increase in sovereign-risk exposures. BHCs with assets between $10 billion and $100 billion were also tightly correlated, but not to the extent of the largest BHCs and principally due to corporate exposures. Mid-size BHCs also saw correlations, but not to the extent of the largest BHCS. Here, these were due to a hybrid mix of increased sovereign and corporate exposures and lacked the persistence evident in risk correlation at the largest BHCs.

This research note also explores the reason for these correlations, breaking down differences within asset classes to hypothesize that the greater concentration of Treasury and cash obligations at the largest banks in 2020 were due to the temporary SLR exemption. The paper concludes that, because heightened big-bank correlation risk is in these low-risk assets, the usual systemic-risk result of high correlation is less pronounced. The shift in corporate exposures also varies due to differences between the corporate line drawdowns at the biggest BHCs that reduced exposures and spikes in PPP loans at smaller ones. PPP loans are of course risk-free, but remaining small and mid-size correlated exposures in P&L corporate lending could prove problematic under stress if these are concentrated in correlated asset classes (e.g., CRE).

Quarles Defines Boundaries of Fed Emergency, Regulatory, Supervisory Policy and Politics

In parting remarks today, FRB Gov. Quarles not only defended his record, but also took a very different stand on future emergency facilities than another departing Fed official, Vice Chair Clarida. Unlike Mr. Clarida's stout defense of 2008 and 2020 actions, Mr. Quarles argues that the credit facilities established in concert with those for emergency liquidity are problematic both in terms of central-bank mission and facility execution. Any future crisis facilities of this sort should, he said, be established by the Fed only if they can be rapidly transferred to fiscal-policy entities.

Looking also at his personal legacy, Mr. Quarles urges his supervisory vice-chair successor to avoid leverage ratio "fundamentalism," instead altering the eSLR to conform to the Basel Committee's approach of a two percent charge atop an adjusted GSIB risk-based surcharge to ensure capital equivalency. He also warns that failure now to revise the SLR will create crises to come. Action on the "Basel IV" package that has yet even to be proposed in the U.S. is also pressed although Mr. Quarles opposes limits on internal-model recognition without offsetting GSIB-surcharge or other reductions because of the capital hike (as much as twenty percent) it could impose. He also recommends SCB averaging to reduce volatility, reduced TLAC recalibration for IHCs and revised calculations for GSIBs, and additional supervisory transparency.

Mr. Quarles also joined Gov. Waller in opposing the stablecoin reforms demanded in the recent PWG report (see Client Report **CRYPTO21**). He defends also many of the rules targeted by his progressive critics, including the stress capital buffer and stress-test transparency. He also reviews his legacy as FSB chair, urging rapid national action on MMF reform and related NBFI margining and open-end fund standards. More work is, he says, underway at the FSB to recommend specifics in all of these areas.

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-120221**: Two recent studies add fuel to the fire we first spotted late last year: demands for ARMs that only go down.
- **FEDERALRESERVE65**: Continuing the partisan and often-acrimonious tone of the Senate Banking hearing (see Client Report **FEDERALRESERVE64**), HFSC today heard from Chairman Powell and Secretary Yellen.
- **CRYPTO22**: Although the OCC joined other agencies issuing a non-committal "roadmap" for future cryptography actions, the agency at the same time and far more decisively stated that crypto activities are permissible only if they are also safe and sound.
- **FEDERALRESERVE64**: Most of the news at today's Senate Banking hearing revolves around Chairman Powell's concession that inflation may not be transitory and economic growth is now so robust that quantitative tightening might proceed more quickly than planned, pandemic permitting.
- **GSE-113021**: Unsurprisingly, FHFA today raised the GSEs' conforming loan limit to about $647,000 and the high-cost limit to nearly $1 million.
- **GSE-112421**: Because FHFA tends to take its cue from both the Basel Committee on Banking Supervision and its U.S. cousins, we here drill down to look at the housing-finance implications of the proposed global framework we assessed in a recent in-depth report.
- **CLIMATE12**: Following the UN's COP26 climate-risk summit, the Basel Committee has proposed high-level principles guiding risk management and supervision related to both physical and transition climate risk.
- **REFORM210**: As expected, today's hearing with Comptroller-nominee Saule Omarova included an unprecedented amount of fireworks for what is normally a low profile appointment.
- **FAIRLEND10**: The CFPB has followed a study earlier this year finding significant mortgage product and price discrepancies based on race or ethnicity with a request for input (RFI) on the HMDA data on which the study was based.
- **GSE-111721a**: FHFA's new scoring system for the GSEs and CSS is a startling, if unsurprising, mission rewrite.
- **GSE-111721**: As noted yesterday, the CFPB has opened its HMDA rules to a raft of changes
- **GSE-111521**: As we noted on Wednesday, the CFPB highlighted Director Chopra's competition focus when it joined other agencies renewing their mortgage-servicing supervisory and enforcement standards.

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- **GSE-111221**: As Mark Calabria made clear earlier this year, reform of the Treasury market has direct, major impact on that for agency debt and MBS.

- **TMARKET2**: In this report, we build on our initial analysis of Monday's report from the Inter-Agency Working Group on Treasury Market Surveillance (IAWG).

- **SYSTEMIC92**: Late yesterday, the Federal Reserve released its most recent financial-stability report. As in its predecessor earlier this year (see *Client Report* **SYSTEMIC91**), this report takes a cautious view, counting on continuing bank resilience to counteract old worries, such as asset-price bubbles, along with containing at least some new fears.

- **CRYPTO21**: As noted yesterday, the President's Working Group on Financial Markets (PWG) was joined by the OCC and FDIC yesterday issuing a report calling for prompt Congressional action to regulate stablecoins and, even in its absence, also for fast action by federal regulators and the FSOC.

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