Wednesday, December 8, 2021

BIS Staff: DeFi Demands Tough Prudential, Governance Standards

As noted on Monday, the BIS has published several policy-making papers targeting different facets of nonbank financial intermediation that are sure to guide both U.S. and global action. In this alert, we assess a study of the "decentralization illusion" arguing that DeFi is considerably more centralized than appearances suggest and that this centralized infrastructure creates "concentration of power" that requires new regulation to prevent operational or even systemic risk as well as near-term potential for illicit finance, undue investor risk, and an array of rent-seeking activities by DeFi insiders.

The BIS study details various centralized DeFi considerations, laying out specifics pertinent to run-risk, leverage, governance failures, and spillovers to both banks and nonbanks. Its policy conclusions regarding stablecoins track those in the PWG report (see Client Report **CRYPTO21**), reiterating the same-risk, same-rules construct without going as far as also to recommend that stablecoins be allowed only in IDIs. Because DeFi is not in fact fully decentralized, BIS staff also state that regulators and supervisors can and should reach key nodes to ensure not only prudential safeguards, but also AML/CFT compliance.

BIS CBDC Experiment Successfully Settles Wholesale FX Transactions

The BIS today ended its joint wholesale CBDC experiment with the French and Swiss central banks, concluding that CBDC can be effectively deployed for international settlements. This is a significant finding and one that surely puts still more pressure on the Fed to issue its discussion draft and then proceed to determine the U.S. role as other major central banks ramp up operations with major market and even reserve-currency impact. The project successfully settled foreign exchange transactions in euro and Swiss franc wholesale CBDCs on a single DLT platform, with tokenized asset and foreign exchange trades settled safely and efficiently using both payment versus payment (PvP) and delivery versus payment (DvP) mechanisms. Testing was conducted in a “near real-life” setting meeting all current regulatory requirements and using real-value transactions. Noting that third-party platform use and non-resident institution direct access to central bank money raise intricate policy issues, the BIS and participating central banks also propose the use of subnetworks and dual-notary signifying to ease central bank concerns, reiterating that use ultimately depends on individual central-bank willingness to issue CBDC.

OCC Defines a "Good-Overdraft" Construct

Acting Comptroller Hsu today advanced the anti-overdraft campaign launched last week by CFPB Director Chopra, arguing that overdrafts disadvantage lower-income households and thus erode the trust essential to an industry success. However, the OCC does not plan to bury overdrafts, but instead to reform them. Saying that programs such as Bank On that eliminate overdraft protect consumers but also limit "financial capacity," the Acting Comptroller said that his agency will build on actions taken at several large national banks to redesign overdrafts so that they enhance financial resilience. It is thus looking at policies such as requiring opt-in to obtain overdraft protection, overdraft-fee grace periods, allowing negative balances, providing real-time balance alerts, linking transaction to other accounts for overdraft purposes, and collecting fees from the consumer’s next deposit after all postings are processed. It is unclear if these options will comport with the CFPB's approach, but we expect there to be considerable compatibility, with the OCC adding teeth to its principles by targeting a few banks that depend on overdraft-fee revenue with safety-and-soundness actions.

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.

- **CRYPTO23**: As anticipated, today's HFSC hearing was a marathon session at which industry witnesses defended their business model, Republicans liked it fine, and Democrats worried about a wide array of policy challenges.

- **COVEREDFUNDS3**: The OCC is "clarifying," but also in many respects rescinding one aspect of controversial 2020 rules expanding the "covered funds" under which banks may make equity investments as provided by the Volcker Rule.

- **GSE-120621**: As we noted on Friday, Senate Banking Ranking Member Toomey asked SEC Chairman Gary Gensler a trick question about GSE obligations at the very end of a lengthy letter focused principally on cryptography.

- **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.

Federal Financial Analytics, Inc.
2101 LStreet, N.W. – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

- **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.
- **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.

Federal Financial Analytics, Inc.
2101 LStreet, N.W. – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com