FedFin Daily Briefing

Tuesday, April 19, 2022

CRA Reform Still in "Soon" Timeframe

In remarks today, Acting Comptroller Hsu provided only a little insight into ongoing negotiations over a new CRA proposal, reiterating that one will "soon" be released. The talk also restated reform priorities, such as redesigning assessment areas and improving examination tools, and detailed the OCC's backing for special-purpose credit programs.

IMF Warns of Payment-System Fragmentation, Dealer-Bank Commodity

The IMF today released more of its annual global financial report, going beyond the assessment of the renewed sovereign doom loop we addressed in yesterday's FedFin alert to consider other financial-stability risks and call for quick action on a new fintech/crypto regulatory framework. In its in-depth assessment of global markets, the Fund in part looks at the impact of sanctions on the global payment system, finding that recent events are likely to fragment payment infrastructure into competing payment and CBDC blocs with adverse implications for global liquidity and payment efficiency. Its recommended solution to this worrisome trend is for sovereign states to seek to avoid it.

The Fund also picks up on the issues in Karen Petrou's *Financial Times* column last week, finding that risk-off market conditions have led to dangerous commodity-market volatility and illiquidity. The report observes that CCP margining practices are leading to a shift to bilateral transactions and broker-dealer trades, exposing dealer banks to the risk of higher CCP margin calls than those covered by their clients. This liquidity risk could lead to counterparty credit risk, as well as those related to concentration and inter-connection. All of this emerging stress may have adverse consequences on end-users in key commodities arenas as well as consumers, accelerating the risk of default – especially for smaller commodities companies. The Fund observes that these trends are now evident on dealer-bank balance sheets, urging nations quickly to enhance market transparency and quickly to review the extent to which financial-market infrastructure in this sector is effectively regulated.

Fed Finds Nonpublic Prime Funds More Resilient

As the SEC contemplates MMF reform (see FSM Report **MMF19**), the Fed has continued to issue reports highlighting vulnerabilities that the central bank likely feels are only partially addressed by the Commission's preferred liquidity fix: swing pricing. Last month, we noted a study finding such severe structural weaknesses across institutional and prime funds as to lead researchers to call for both floating rates across the sector and bank-like prudential reforms. A new study does not directly address regulatory concerns, but, for what it says is the first time, segments the institutional prime sector into funds offered to the public and bespoke funds, finding that public institutional prime funds had considerably greater run risk than non-public offerings. This is, the study posits, because nonpublic fund investors are more concentrated and likely to internalize redemption risk. Given the greater size of the nonpublic sector, one possible regulatory option the SEC might elect is controversial standards such as swing pricing only for public funds, but the lack of any discussion of this approach would appear to make that an unlikely compromise.

IMF Calls for Fast, Tough Fintech, DeFi Regulation and Supervision

The IMF's overarching financial-stability report not only deals with the structural risks addressed earlier today, but also those posed by fintechs and DeFi. As presaged in its blog post last week, the report concludes that fintechs pose risks both on their own and to less technologically advanced banks, each of which requires regulatory action to prevent systemic risk. With regard to DeFi, the Fund is at least as dubious as IOSCO, which has already laid out a raft of centralized points on risk posing financial and counterparty hazard (see *Client Report* **DEFI**). These, the Fund argues, warrant rules for stablecoins, regulated centralized crypto exchanges, and governance standards addressing conflicts of interest.

The fintech analysis focuses on deposit-taking and credit intermediation despite rapid change in other financial sectors. Going beyond prior analyses, it adds an assessment of bank/fintech partnerships, identifying these as risky due not only to regulatory arbitrage, but also concentrated infrastructure with systemic ramifications. "Neobanks" are found to have market capitalization equal to that of incumbent banks in some nations, demonstrating near-term systemic risk along with higher credit-risk profiles, lower provisioning, illiquidity, and more vulnerable customers at increased risk due to cross-selling incentives embedded in many fintech business models. The report recommends an array of prudential standards as well as close supervisory scrutiny of incumbents deemed unlikely to innovate.

Carstens Endorses Fed's Cautious CBDC Stance

In a discussion about the future of digital money during the IMF annual meetings, BIS General Manager Carstens endorsed Federal Reserve Chairman Powell's cautious approach to creating a CBDC (see FSM Report CBDC10), citing the critical importance of reliability to CBDC success. Nonetheless, he also reiterated that CBDC is the only crypto instrument that could serve as money, labeling cryptoassets and stablecoins as just speculative assets and emphasizing the need to keep central banks central. In addition, Mr. Carstens listed increased inclusion, faster cross-border payments, efficient disaster relief or wartime aid, and protection of monetary sovereignty as potential CBDC benefits.

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.

- **CBDC11:** As promised, we turn here to an in-depth analysis of a paper from global regulators on whether CBDC contributes to financial inclusion – one of the most vital arguments from those advocating CBDC in the U.S. and in many other nations.
- **GSE-041522:** Cementing her very different vision of Fannie and Freddie, Acting Director Thompson has now finalized a new strategic plan for the FHFA emphasizing the importance of both equitable and sustainable housing finance
- **CBDC11:** Progressive Democrats in the House have introduced an alternative digital-dollar proposal ("e-cash") to the "FedAccount" construct urged by Senate progressives that mandates an electronic currency created by the Treasury Department to devise an electronic substitute for physical fiat currency.
- **GSE-040722:** FHFA has finalized new capital rules for the GSEs designed to accelerate the credit-risk transfer the agency now deems essential for a fast-acting conservatorship exit.
- **SANCTION18:** As anticipated, today's HFSC hearing with Secretary Yellen largely focused on ways to sanction the Russian Federation and its allies and associates.
- **DEFI:** As promised, this report provides an in-depth analysis of IOSCO's new paper on decentralized

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finance, one sure to advance the FSB's efforts to bring DeFi systems under greater regulatory scrutiny due to the findings we here detail.

- **GSE-032222:** As detailed in our new in-depth analysis, the CFPB's exam-manual rewrite dramatically redefines the compliance-, legal-, and reputational-risk terrain for any consumer-financial company and the vendors or counterparties on which it relies.

- **CONSUMER39:** Reflecting one of its new director's top priorities as well as that of the Biden Administration, the Bureau of Consumer Financial Protection has significantly revised its examination manual when it comes to behavior that might be viewed as discriminatory in a wide range of consumer-financial products, services, underwriting, advertising, marketing, governance, and other arenas.

- **SANCTION17:** The Senate Banking Committee's hearing today on illicit finance focused as expected on cryptocurrency and suggests that targeted legislation addressing specific jurisdiction or compliance issues might advance on a bipartisan basis.

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