FedFin Daily Briefing

Thursday, June 2, 2022

Fed Study Outlines Fixes to Make Retail CBDC Functional

A new Federal Reserve paper assesses the interplay between a U.S. retail CBDC and monetary policy transmission if whatever the Fed comes to offer is widely adopted for both payment and investment purposes. The study's own conclusions suggest that many adverse CBDC implications could be readily offset, but it acknowledges that neither it nor other analyses have adequately explored critical issues such as implications for nonbank financial intermediation. We would also note that one proposed CBDC fix – a new Fed liquidity facility to bolster banks as CBDC takes their deposits – poses an array of policy and political questions.

The paper also finds that, to the extent that demand drained reserves from the banking system, there would likely be upward pressure on the Fed funds rate. However, the Fed is said to be able to counteract this by using current policy tools (e.g., open-market operations to increase bank reserve balances). The study reaches these conclusions using models for households, banks, and Fed balance sheets, assuming a CBDC akin to that outlined in the Fed's discussion draft (see FSM Report **CBDC10**) that operates at a time when the Fed holds a large portfolio that is backed by Treasury obligations and does not pay interest. The study also assumes that the aggregate demand for reserves at banks does not change following CBDC introduction, a condition the study readily acknowledges might not hold. The paper does note that CBDC introduction could be initially disruptive to banks but suggests that this might not have an adverse effect on overall lending because banks could fund themselves from FHLB advances, higher-cost funding, or even a new Fed liquidity facility to ease the transition to a CBDC. The paper also finds possible adverse effects in the nonbank money market but does not spell them out beyond noting that overall funding costs would likely rise due to CBDC competition. Further, were the CBDC to pay interest or be widely used by businesses, then the impact on banks and the money market would likely be considerably greater; allowing foreign holdings of the U.S. CBDC could also increase demand for it and thus also the size and volatility of the Fed's balance sheet along with global spillover risk.

Black Crypto Investments Reflect Wealth Gap Born of Financial System Distrust

A new article by the Kansas City Fed investigates the popularity of cryptoassets among Black investors and explains what may attract them and how this is a symptom of the racial wealth gap. The study found that Black investors are both more likely than whites to own crypto instead of safer assets such as stocks and mutual funds and more likely to expect high returns (i.e., 27 percent for Blacks versus 15 for whites) from crypto. The study also poses two possible explanations for this phenomenon: first, Black investors may see crypto as a fast way to bridge the wealth gap because they expect crypto's decentralized nature to give them a more equal chance of wealth accumulation. Second, distrust of the financial system may have driven many Blacks to crypto. The KC Fed concludes that the willingness of Black investors to gravitate towards unproven and risky assets signals the severity of the racial wealth gap and the need for meaningful solutions to address Black distrust of and lack of access to traditional finance.

Fed Study Finds Enforcement Actions Increase Minority Lending

A study today released by the Fed found that, since 1997, banks subject to an enforcement action increased their mortgage lending to minorities and decreased minority denial likelihood, even if the action was not issued for violation of the fair-lending laws. Lending increases resulted from improved credit assessment and corrective actions that resulted in less reliance on nonprice terms for loan approvals, improved loan policies, and stronger governance. The study also found no evidence that the increase in minority lending derived from either attempts to improve capital ratios by expanding mortgage lending or competitive pressure from banks not under an enforcement order. This increase was also not associated with riskier or lower quality loans. The study's authors also noted that more severe actions specifying revision to loan policies or implementation of internal governance procedures both resulted in higher minority lending rates.

FIO Prioritizes Biden Climate-Risk Goals

The meeting today of FIO's Federal Advisory Committee on Insurance focused on FIO's work to meet the goals set out for it in the President's climate-risk executive order (see FSM Report **GREEN8**). FIO is considering the extent to which its statutory authority (see FSM Report **INSURANCE26**) allows it to mandate data collections that would support transition and physical risk analyses as well as an assessment of insurance-coverage disruption risk. FIO will issue a climate report by the end of the year focusing on insurance supervision gaps and resulting systemic risk. FIO is also working with the FSOC, IAIS, and NAIC on issues such as macroprudential analyses, supervision, and scenario analysis, and is also planning stakeholder roundtable discussions on climate-related financial risk relevant to the insurance sector.

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-060222:** Following on the heels of new capital disclosures, FHFA has finalized a planning process designed to ensure that GSEs have something good to say when they post these reports, reassuring markets and perhaps even speeding the way out of conservatorship.

- **GSE-060122:** As detailed in our new in-depth report, the CFPB has issued another sweeping rule by way of a seemingly innocuous circular not subject to public notice and comment.

- **FAIRLEND11:** Continuing its use of novel rulings that preclude public notice and comment, the CFPB has issued a landmark ruling on artificial intelligence (AI) and other forms of algorithmic underwriting stipulating lender responsibility for sending out the adverse action notices required under the Equal Credit Opportunity Act (ECOA).

- **GSE-052722:** FHFA has finalized its October proposal to create a new qualitative capital and governance disclosure regime, going well beyond the disclosures initially mandated in the final capital rule to instill market discipline long associated with private companies, not conservatorships.

- **CBDC13:** Newly in place as Fed Vice Chair, Lael Brainard today made it clear at an HFSC full committee hearing that her prior statements laying out CBDC benefits are still her thinking despite the considerably more ambivalent approach outlined in the Fed's discussion draft (see FSM Report **CBDC10**).

- **DEPOSITINSURANCE113:** Using a new approach to issuing enforcement edicts – a circular – the CFPB has made use of its controversial decision to bring nonbanks under its ambit to bolster the FDIC's efforts to enhance consumer understanding of which funds are entrusted to FDIC-insured depositories and which may be at greater risk in other hands.

- **CRYPTO27:** Sharp disruptions in cryptoasset markets, and especially those for stablecoins, have energized calls for rapid U.S. statutory and regulatory action along lines initially laid out by the President's Working Group on Financial Markets (PWG).

- **CRA32:** Following much talk about the need to update Community Reinvestment Act (CRA) rules since this was last done in 1995, federal banking agencies have finally agreed on a proposed redesign of standards essential to banks that wish to expand or acquire as well as those seeking strong community ties and the policy and political benefit these afford.

- **GSE-051622:** As we noted last week, the federal banking agencies sighed a mighty sigh and heaved up a massive inter-agency proposal rewriting decades-old standards detailing which activities earn the Community Reinvestment Act (CRA) points essential for any bank's strategic objectives and national reputation.

- **FSOC27**: With stablecoin markets even more distressed than earlier in the week, today's HFSC hearing with Secretary Yellen was even more emphatic than senators two days before on the need for action (see *Client Report* **FSOC26**).

- **FSOC26:** Today's Senate Banking Committee hearing with Secretary Yellen renewed calls for federal legislation based on recent algo-coin losses and resulting digital-currency market volatility.

- **SYSTEMIC93:** In this report, we assess the new Federal Reserve financial-stability report.

- **CRA31:** The FDIC today led the way with release of a long-awaited inter-agency proposal updating decades-old CRA regulation.

- **CLIMATE13:** The FSB's report is aimed at establishing global standards that prevent fragmentation along national or regional lines as well as ensuring that regulatory and supervisory actions mitigate climate risk to the greatest extent possible in the face of an array of data and measurement challenges.

- **INTERCHANGE9:** As anticipated, bankers and card networks squared off with merchants at today's Senate Judiciary hearing addressing credit-card interchange fees.

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