FedFin Daily Briefing

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Fed Develops a Measure of Operational-Risk Exposures

In a research note late last week, Federal Reserve staff proposed a new approach to quantifying a bank's operational-risk exposure, a timely contribution to the debate sure to rage when the U.S. advances Basel's proposed rewrite of operational-risk-based capital requirements (see FSM Report **OPSRISK18**). The report notes recent FSB efforts to strengthen operational resilience via current Fed supervisory standards (see FSM Report **OPSRISK15**), going on to construct what it calls a "basic methodology" of operational interconnections to estimate the impact of severe disruption using Fed-supervisory data on the largest U.S. banks and financial-market utilities.

The paper focuses on the payment system and thus considers itself a limited sample but also a meaningful example of how resilience mapping and quantification could proceed. Its model for first-order risks in the payment system leads to an estimate of $1.4 trillion before recovery begins. The paper does not propose its methodology as a new approach to setting capital, but it suggests it suffices to judge risk mitigation and tolerance thresholds. As such, it could significantly improve the capital requirements, which continue to discount risk mitigation such as insurance and recovery/resolution-planning stress results despite widespread recognition that these may better reduce operational risk than capital buffers (see forthcoming FedFin paper).

FHLB Banks Said to Pose Grave Risks, Require Reform

A new paper from Fed staff and former Gov. Dan Tarullo argues that the Federal Home Loan Banks pose structural problems to federal bank regulation and systemic stability by virtue of their hybrid status and the absence of clear purpose under contemporary market circumstances. The paper describes the FHLBs and their various privileges in the context of an implicit guarantee and what it believes to be self-interested governance, noting that FHFA oversight has yet to take account of the changing role of the FHLBs and resulting risks. The paper acknowledges the liquidity value of FHLB advances in the great financial crisis, but argues that recent developments make uncertain the extent to which the Banks could withstand more stress that might force Federal Reserve market intervention given the moral hazard attendant to the Banks themselves and current market expectations about continuing funding to ensure both bank and MMF liquidity under stress. MMFs are now the System's principal funding source, with the paper detailing how a change in MMF sentiment or a run under stress would adversely affect the fed-funds market given the Banks' dominant role in a sector essential for Fed policy and market stability. However, member-bank liquidity under stress appears assured due to the favorable terms on which advances are now provided.

Noting also that opacity prevents a full understanding of FHLB risks and activities, the paper nonetheless recommends several policy responses to which the agency should turn given the likely absence of Congressional action unless or until there is another crisis. These actions include increased transparency akin to that demanded of both bank regulators and the banking agencies for FHFA and the FHLBs, standards to prevent high-risk maturity transformation, and regular FSOC review of FHLB risk and steps to prevent the System from continuing to hinder the work of other federal financial regulators. FHFA director Thompson has indicated that she is willing to convene an advisory committee on the Banks, but no action has been taken to form one.

FRB-New York: Digital Currencies Could Strengthen the USD

Contrary to Congressional fears (see *Client Report* **CBDC13**), a new blog post from the Federal Reserve Bank of New York projects that digital currencies might bode well for the continued international dominance of the dollar. Indeed, they find that pegging stablecoins to the USD could actually reinforce the dollar. Further, most CBDCs have focused on domestic retail sectors and would thus not challenge the dollar's international status, although the authors do not directly explore the implications of foreign CBDCs without the U.S. adopting one of its own. They also find that existing obstacles to use of non-dollar local currencies (e.g., credit and liquidity risks) might spill over to their digital currencies and even that CBDCs in small open economies could strengthen the dollar if they are backed by the USD.

Liang Calls for New-Age CCyBs, Open-End Fund Reform, Digital-Asset Macropru

In remarks today, Treasury Under-Secretary Liang concludes that post-2008 macroprudential standards strengthened the financial system as evidenced by its ability to support the real economy in 2020. However, adjustments to bank capital and CCP margining along with NBFI reform are, she says, still required in the wake of 2020's experience and to meet new challenges. She is particularly focused on counter-cyclical capital buffers (CCYBs), noting how well they worked in nations that had imposed them before 2020, suggesting that better buffer-related communication (e.g., set time periods) might make them more useful in nations (i.e., the U.S.) that did not trigger them. Ms. Liang also recommends a CCyB for the leverage ratio expressly tied to low-risk assets to ease liquidity stress in markets such as those for Treasury obligations and surprisingly suggests policy that encourages bilateral clearing to reduce CCP-margin stress, reinstating the system that preceded the great financial crisis that led to regulatory demands for greater CCP reliance. She also calls for open-end fund reform by changing investor redemption rights with swing pricing and perhaps also by creating new types of open-end funds with less liquidity mismatch risk. Ms. Liang also argues that digital assets are in many ways no different than traditional assets except with regard to how they bypass regulated intermediaries. As a result, the current macroprudential framework is well-suited for digital assets if it can be made to apply to them. It is likely that Treasury's report on digital assets pursuant to the President's executive order (see *Client Report* **CRYPTO26**) will focus on this question as well as on the new stablecoin policy outlined last week by the FSOC.

Global Regulators Find Risky Connectivity Between Banks, BigTech

The BIS Financial Stability Institute today released a report investigating what it calls the regulatory blind spot of bigtech inter-dependency, recommending that regulators develop an entity-based regulatory framework for bigtech operations in the financial sector and, while they work on this longstanding goal, use an new, indirect approach. Under it, regulators would evaluate potential risk mitigation for financial entities in bigtech groups, assessing their ability to withstand stress and intensifying monitoring of critical third-party service providers. The report finds that the existing regulatory framework does not account for the closely connected digital ecosystems common in bigtech because regulators miss key risks such as the fact that financial entities that form part of

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a bigtech group may use a common payment system to facilitate transactions across the ecosystem, as well as rely on a common technological infrastructure and credit-scoring systems. In addition, FSI found that the products that financial institutions and bigtechs offer through partnerships are often opaque, making it unclear whether the products may encourage riskier behavior.

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.

- **CREDITCARD35:** Taking the first concrete action following its new policy on "junk fees," the CFPB has sought public comment on whether and how to govern credit-card late fees and broader practices related to late payments.
- **GSE-070122:** FHFA today essentially conceded after its initial polite rebuff to an Urban Institute critique of the capital rules adverse impact on UMBS.
- **GSE-063022:** The Federal Reserve Bank of Philadelphia's latest report on foreclosure risk includes a worrisome finding: the sharp rise in interest rates means that most loan-mod recipients won't actually get much relief.
- **GSE-062922:** In response to a request from its Inspector General, FHFA renewed the commitment to fourth-party supervision.
- **DEPOSITINSURANCE114:** The FDIC is proposing to raise base Deposit Insurance Fund (DIF) assessments by two basis points (BPS) to replenish the DIF by the statutory deadline to reflect deposit inflows that the FDIC no longer expects to be temporary.
- **GSE-062722:** A new Fed paper analyzes the striking differences between mortgage-market liquidity – or the dramatic lack thereof – in the great financial crisis of 2008 and the pandemic crisis of March, 2020.
- **FEDERALRESERVE71:** At today's HFSC hearing, Chairman Powell encountered the same political headwinds evident at yesterday's Senate Banking session (see *Client Report* **FEDERALRESERVE70**), reinforcing and even heightening his commitment to fighting inflation in concert with hopes that a soft landing may still be possible.
- **GSE-062322.pdf:** Following a sharp critique of GSE capital standards earlier today from the Urban Institute, FHFA Director Thompson today acknowledged Fannie and Freddie's new 50 bps fees when one of the GSEs guarantees the other's collateral for UMBS purposes.
- **FEDERALRESERVE70:** As we expected, today's Senate Banking session with Chairman Powell is a preview of broader national debate ahead of the midterm election.
- **CLIMATE14:** The Basel Committee has finalized its proposed climate-risk management principles largely unchanged from its proposal, establishing over-arching goals at which both banks and their supervisors are asked to aim.
- **CONSUMER43:** Combining some of its outstanding initiatives and adding new ones, the CFPB is

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seeking information on how well larger banks and credit unions serve consumers and what steps may be needed to make them do better.

- **GSE-061522:** Today's report to Congress is FHFA's first foray into expressing a statutory opinion since Sandra Thompson took over, a change doubtless due to her newly confirmed status and the will to tackle hard questions in which Congress has only nominal interest in the absence of another crisis.

- **CRYPTO28:** After protracted negotiations and much public attention, bipartisan senators have introduced a far-reaching bill designed to encourage digital-asset use without undue risk to consumers, investors, or the financial system.

- **GSE-060922:** When Sandra Thompson earlier this year enunciated a new equitable-finance mission, we forecast that Fannie and Freddie would undertake an array of new activities that significantly expand their footprint along with their equity and equality impact.

- **GSE-060722:** FHFA released its first-ever report on the extent to which Fannie, Freddie, and the FHLBs meet their statutory mission.

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