Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Last week, the *American Banker* had a synopsis of views filed on Treasury's request for comments on digital-finance regulation. Its quote from the ABA's comment letter is striking, indicating that this letter pointed to the increasingly-absurd reality of no rules for nonbanks and no digital assets for banks given all their rules. Progressive advocates pushed back, arguing that it's right to keep banks quashed because of all the systemic hazards they pose. To my thinking, both sides are right, with recent history not just showing why, but also how urgent it is for regulators finally to act on both overarching crypto rules and those governing bank exposures in this volatile sector.

The recent history I have in mind is the chilling precedent of subprime mortgages starting in around 2003. I well remember a meeting at the OCC in which my late husband detailed both the borrower and market risks of new mortgage products such as those with "silent seconds" extended to borrowers with no demonstrable ability to repay even a first line from resources other than the ever-appreciating house prices investors somehow believed were a force of nature that always blew balmy winds their way.

The OCC official with whom we spoke was even more worried than we about emerging market trends, but she was over-ruled from on high. This was first because national banks weren't sounding the alarm, second because no other banking agency seemed worried, and finally because anything that adversely affected national banks might have undermined their competitiveness and, we inferred, also damage that of the OCC.

To be sure, the problem at this early stage in subprime-mortgage finance was largely outside the banking sector, with lots of finance companies ginning up creative products with scant, if any, regard for credit risk because the secondary market was hungry for high-yield paper. Early warnings from a credible regulator could, we thought, alert banks, the Fed, the FDIC, and – perhaps most important – the SEC, OTS, and Office of Federal Housing Enterprise Oversight (FHFA's hapless predecessor). Again, word from on high: it's not the job of a bank regulator to warn investors and there were only a few indications of national banks yet playing any role in high-risk mortgage finance. When this changed, come on back.

With few official warning bells, subprime lending ran amok. In 2006, Senate Banking grew worried and convened a hearing at which the then-four banking agencies were called to testify. As we noted at the time, all of the banking agencies saw no risk because they believed bank involvement in subprime finance was minimal. Where it wasn't, they were each sure that examiners were doing a heck of a job. The OTS was the most reassuring of all these agencies even though one of the thrifts it governed was soon to become the largest failure ever of an insured depository.

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From this quick tour of what is now a well-known systemic calamity we first draw the lesson that high-flying markets pose risks even where banks aren't much involved and bank regulators must do their best under current law to ensure that these risks are curtailed. When it comes to crypto, this means working with Treasury to finally address risks in meaningful, hands-on ways instead of continuing to study and hopes that the SEC or financial market will take care of the worst practitioners before they do still more harm to innocent bystanders or the financial system.

The second lesson of this sorry history is that banks are always at risk because their liquidity and even solvency depend on that of the economy and on systemic stability no matter how high their capital and liquidity buffers may seem. Even if bank exposures appear minimal to digital assets, the scope of market exposure combined with increasing financial-system adoption now argues for rapid action to set sensible, yet stringent rules for direct and indirect higher-risk digital exposures. That way, banks can compete and the markets in which they do so are less likely to implode to their disadvantage and that of the economy and financial system that still depend on banks.

The third lesson is more supposition than proven: what if banking agencies had acted as the OCC official urged early on and instituted sensible standards for sound credit to higher-risk mortgage borrowers? Might we now have a more equitable housing-finance system instead of one that went through a systemic wringer at grave macroeconomic cost and, lessons from that learned, now largely excludes all but the affluent and is dominated by all but the banks? We'll never know, but we can prevent a repeat in which cryptoassets proliferate ungoverned outside the banking system, banks do everything they can to meet market demand, and what should have been an exciting new way to expand financial inclusion, speed payments, and increase market efficiency blows up.