FedFin Daily Briefing

Thursday, October 20, 2022

Fed Staff Study: Climate Risk-Based Capital Impossible for Foreseeable Future

FRB staff released a stylized study of one critical climate-risk policy question: the extent to which banks should hold capital against it. Members of Congress have suggested this over recent years (see FSM Report **GREEN9**) and the BIS at the outset of its thinking recommended both "brown-penalty" and "green-incentive" capital charges (see *Client Report* **GREEN**). This paper doubts the ability of any climate-risk capital charge actually to buffer risk given the difficulty now of precisely estimating climate risk's loss-generating potential and uncertainty about the policy objectives any such capital requirement should achieve. The paper's models also reflect the need to ensure that regulatory-capital requirements are market-efficient to the greatest extent compatible with whichever objective is selected. Such a capital charge might be possible in the future, the paper concludes, but for now any capital costs related to climate risk should be handled via Pillar 2 capital charges, if at all.

We would note that some of the criticism the paper poses to imposing risk-weight assessments on climate risk are applicable to other credit or market exposures where quantification is uncertain and, when it comes to buffers and surcharges, where the balance between safety-and soundness and financial-stability has become blurred. However, the paper provides a stylized – i.e., relatively simple – analysis of key features of Basel III in the climate-risk context, an exercise not to our knowledge attempted for other capitalized risks. The paper's assumption is that regulatory capital is intended principally to absorb unexpected loss, the primary purpose set forth in virtually every regulatory-capital edict. Given this, the paper suggests that it might well be that forward-looking loan-loss reserves for expected loss and risk-based pricing best handle climate risk. The paper does not address the BIS goals noted above – i.e., using capital to achieve climate-risk mitigation. However, its model and analyses suggest that this is impracticable at the present time and, quite likely, at any time given the complexities of differentiating climate effects and at the same time ensuring market efficiency and resilience.

FSB Presses for MMF, Open-End Rules; Government-Bond CCPs

Continuing its NBFI focus (see *Client Report* **NBFI**), the FSB today issued new recommendations to address government-security market illiquidity. Even as it does so, however, the FSB now concedes that even if there is action on all of its recommendations – and it clearly thinks this unlikely – markets will remain inherently unstable under stress. Its recommendations build on its final MMF-reform recommendations (see FSM Report **MMF18**), with global regulators now calling on national jurisdictions to finalize MMF standards and address open-end funds. The SEC plans to do so and will next week take up new disclosures, but Chairman Gensler also plans to look at swing pricing and other open-end remedies as pressed also by Fed and Treasury officials. The FSB is also pushing central clearing for government bonds, another step now under way in the U.S. However, the FSB wants to go farther, focusing also on repo central clearing and advancing all-to-all government-bond markets. This last recommendation conflicts with the call for central clearing, but the FSB is concerned that many jurisdictions cannot ensure central clearing and that nonbanks may not be sufficiently robust counterparties for all-to-all markets to function under stress. As is often the case, the FSB also calls for closing market-data gaps and greater international cooperation.

Gruenberg Gives No Clue as to Timing, Content of Inter-Agency Crypto Guidance

In remarks today, Acting Chairman Gruenberg reiterated the risks laid out in the FSOC digital asset report (see *Client Report* **CRYPTO33**), repeated warnings against misrepresenting FDIC deposit insurance, and announced forthcoming interagency crypto guidance without providing any details or timeline. He listed the dynamic nature of the cryptoasset market, the lack of user recourse, and difficulty in ensuring AML/CFT and consumer protection compliance as digital asset's major risks. The Acting Chairman also noted the potential benefits of a payment stablecoins, but called for them to be subject to federal prudential regulation, required to be backed dollar-for-dollar with high quality short-dated Treasury assets, and only allowed over permissioned and regulated ledger platforms. He also highlighted several policy questions regarding the possibility of effective and widespread payment stablecoins, which include the extent to which nonbanks should be allowed to issue them, ensuring proper disclosure and consumer protection, ensuring that their design contributes to financial inclusion, and how a private payments stablecoin would interact with FedNOW or a potential CBDC. When asked whether FSOC would use its designations authority on stablecoin activities or firms, the Acting Chairman cautiously answered that using that power "was of interest to some FSOC members."

Bipartisan Senators Press Secondary Sanctions for Enactment

Sens. Toomey (R-PA) and Van Hollen (D-MD) released a readout of a conversation with the Ukrainian Ambassador on the upcoming G7 Russian oil price cap, positioning their oil sanctions amendment for inclusion in the National Defense Authorization Act (NDAA) in light of the Ambassador's support for it. Their bill gives the Administration the authority to levy secondary sanctions on entities that purchase Russian oil above the cap and automatically decreases it after three years to further deprive Russia of its oil profits. The Administration has so far opposed this language on grounds that it would make enforcing the oil price-cap even more difficult, but the idea has broad bipartisan support in both Houses. As previously noted, Treasury's rules governing financial institution sanction compliance related to the price cap will require financial institutions to enforce the sanctions with the best of their knowledge.

Warren Calls for Stronger, More Transparent CFPB Remittance Rule

Joined by four Senate Democrats, Sen. Warren (D-MA) today sent a letter to CFPB Director Chopra asking that the agency strengthen its remittance rule to ensure greater transparency for exchange rates and fees it calls "hidden" and "harmful." Citing optional disclosure loopholes that she believes allow remittance providers to advertise low or no fees while "inflating" exchange rates and/or "misrepresenting" third-party costs, the letter specifically calls on the Bureau to require providers to display mid-market exchange rates and limit additional revenue collection to added costs. The CFPB is also asked to rescind its permanent exemption for non-covered third-party fees and encourage transparency through adoption of new technologies.

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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.

- **MERGER11:** As promised, this analysis focuses on the OCC and FRB approvals of the acquisition by U.S. Bancorp of MUFG's Union Bank in California.

- **DEPOSITINSURANCE115:** The FDIC board today voted 3-0 to increase DIF assessment rates by 2bps, finalizing its proposal (see FSM Report **DEPOSITINSURANCE114**) and rejecting industry arguments on grounds that a small DIF premium increase now would make a more damaging procyclical assessment increase under adverse economic conditions less likely.

- **CRYPTO34:** Speaking for global banking, securities, and insurance regulators, the Financial Stability Board has taken its firmest stand to date on cryptoassets and outlined high-level and often principles-based global standards to govern them going forward.

- **INTERCHANGE11:** Leaving its interchange-fee restrictions intact – at least for now – the Federal Reserve has finalized its proposal expanding on its existing requirement that all debit- card transactions must be enabled for processing on at least two unaffiliated payment-card networks for card-not-present transactions.

- **GSE-100622:** FHA's request for input on small-dollar loans could mean much for this equality-essential product or little beyond a lot more public debate.

- **CRYPTO33:** In this report, we build on our initial assessment of FSOC's conclusion that cryptoassets now pose systemic risk and the Council's recommendations about what should be done to curtail it.

- **GSE-100422:** Although one witness at the FHFA listening session on the Home Loan Banks took strong issue with their mission and meaning, another who called them the "most successful program of the last hundred years" pretty much summed up today's testimony.

- **GSE-100322:** Our take on the first two days of FHFA's FHLB "listening session" last week is that battle lines are shaping up much as we expected with the exception of a couple of powerful groups with new ideas about how the System could be put to better use for themselves and/or the public interest.

- **MORTGAGE121:** The CFPB has asked for views on the extent to which it can facilitate certain refinancing (refi) products it believes enhance economic justice.

- **GSE-092622:** As will be evident in our forthcoming in-depth analysis, the CFPB's fusillade last week on mortgage-finance could have far-reaching implications for the entire market based on how far it takes its new campaign for equitable housing finance and whether the market is willing to come along on at least some of the agency's new ideas.

- **AML136:** Treasury is seeking comments on issues raised by the President's executive order (EO) on digital assets to guide further work curbing illicit-finance and national-security risks in this sector.

- **REFORM213:** Senate Banking's hearing with big-bank CEOs proved much more combative than HFSC's session yesterday (see *Client Report* **REFORM212**).

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- **GSE-092222:** In this report, we follow our earlier analysis of Treasury's CBDC recommendations and housing finance with an analysis of another Treasury report in response the President's executive order focused on the overall construct of cryptoassets in the U.S.

- **REFORM212:** At today's big-bank oversight HFSC hearing, Committee Democrats focused on each bank's progress on social issues, such as internal diversity, unionization, and historic roles in financing slavery.

- **GSE-092122:** In this analysis, we drill down in Treasury's high-impact reports to the President on the future of digital assets to identify key considerations and strategic implications for housing finance.

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