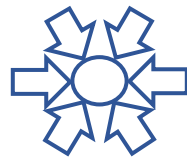


Issue Brief

2023: A Year of FinReg Finales and Congressional Compromise



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In this brief, Federal Financial Analytics (FedFin) lays out our forecast for decisive action on 2023's game-changing U.S. financial-policy decisions in 2023. Yes, we know – much has been said about Congressional gridlock due to sharp differences between House Republicans and Senate Democrats along with the GOP's slim hold on the House. But one of our fundamental, time-tested forecasting rules is to expect Members of Congress to think first, foremost, and pretty much all of the time about themselves. With the 2022 midterm teaching them that the electorate wants governance, all but the most ideological Members will do their best to give it some. This isn't to say that there won't be partisan differences – see below for some big ones. The speakership battle shows how divisive these minorities will prove, but we think the House Financial Services Committee will report out enough bills with sufficient moderate Republican and Democratic support to advance with decent odds in the Senate. We also think Congress will have a lot of impact on financial regulation by virtue of powerful rhetoric and its hold on several agencies' purse strings.

And, just as Members of Congress watch their own back, so too do federal regulators. Each knows he or she is facing the 2024 election as a deadline for substantive reforms delayed over the first two years of the Biden Administration by very, very slow going on key nominations. Again, with themselves in mind, none of the financial regulators did anything they could avoid until their personal fates were settled. With the significant exception of Acting Comptroller Hsu, this is now the case and – acting or not – Mr. Hsu will join his colleagues in consequential action.

Importantly, this forecast does not project where shifting, tectonic-scale forces may also drive or even upend financial policy. FedFin has done extensive work on these forces, including decisive factors such as geopolitical stresses that drive both supply and demand as well as the extent to which the global financial system will continue to decouple in 2023. We are also keenly aware of the impact these forces might well have on credit prices and a particularly fragile systemic node: foreign-exchange clearing and settlement. Add to these structural considerations U.S. political instability, Covid's continuing excruciating impact, and the potential for a significant recession and it's clear accurate policy forecasting cannot be premised on straight-line projections from 2022. None of our forecasts do so, but severely-adverse scenarios are generally not addressed.

U.S. Congress

First to key financial-policy actions in the U.S. Congress we forecast based on an array of leading indicators. We prioritize actions with binding impact, but note also debate with potential to change regulatory decisions and/or public pressure on financial companies.

- **Federal Reserve Construct:** Shortly before the last Congress adjourned, retiring Sen. Toomey (R-PA) introduced several bills tackling the key aspects of the Fed's [structure](#), [accountability](#), and [transparency](#). One of these was even co-sponsored by Sen. Warren (D-MA) and a prominent Republican likely to be on Banking in the next Congress. Sen. Tillis (R-NC) was also joined by all other panel Republicans in a [pledge](#) to redesign the Fed. Some aspects of what the GOP wants are no-gos for Democrats – e.g., a mandatory monetary-policy rule – but there are many areas of agreement and we expect some quickly to be advanced in concrete legislation.
- **Interest on Reserves/ONRRP Assets:** We also forecast bipartisan efforts to recapture tens of billions now going to financial companies to reduce the federal deficit. As noted [elsewhere](#), this

in the past has been a bipartisan issue and is likely to be so again in this Congress even though Members will disagree on what federal revenue recaptured by interest restrictions funds what spending.

- Cryptoassets: FTX's meltdown has confirmed even those previously inclined to let cryptoassets alone that a tougher regulatory construct is needed than advanced in the [last Congress](#). We expect a plethora of proposals early in the new Congress but it remains wholly unclear if Senate Banking Chairman Brown (D-OH) will advance any within his jurisdiction or rely on regulators to redesign U.S. digital finance. Even if Sen. Brown is inclined to advance a bill, any demands by the GOP that it govern the SEC are likely to derail it. That said, bipartisan stablecoin legislation is set to advance in the House if incoming Chairman McHenry (R-NC) finally reaches [agreement](#) with former Chairwoman Waters (D-CA).
- CBDC: The Administration's digital-finance [policy](#) is considerably more sympathetic to a U.S. CBDC than the Federal Reserve's official posture to date. House Republicans will press hard to make it clear to the Fed that the House does not give CBDC the approval the Fed says it will seek from Congress and the White House even though the Fed has yet to make clear what would actually constitute "approval." Republicans can and will talk tough, but Democrats will block GOP efforts to pass a bill banning CBDC. This leaves the terms of engagement fluid no matter how hard Republicans press and thus, as always, making CBDC first and foremost a Fed call.
- ILCs: Shortly before the end of the last Congress, Sen. Brown also introduced long-awaited legislation to curtail nonbank ownership of [insured depositories](#). It remains to be seen if he means to reintroduce this and then press for Senate action. Should he do so, the House GOP will be sympathetic to some version of the Brown bill due to effective small-bank advocacy. However, the extent to which both sides of the aisle on each side of the Capitol comes to agree remains to be seen not only due to the complexities of anti-ILC legislation, but also the uncertainties about the extent to which anyone will be willing to work with anyone else on an issue outside the headlines that may seem largely rhetorical. However, even if this process advances fitfully or not at all, the FDIC will approve no new ILCs and it and/or the Fed may well roll back at least one recent [approval](#).
- ESG: Republicans are on a high-profile roll when it comes to blasting ESG finance. The most concrete proposal to come of this was one from all [Senate Banking Republicans](#) suggesting that investment-fund ESG objectives expressed via [proxy voting](#) conflict with passive-ownership restrictions that insulate them from being declared bank holding companies. Democrats will block any legislation mandating this or more broadly banning ESG, but the Fed recently announced that it will [take a look](#). We think nothing substantive will come of this from the Fed, but one never knows how lawyers may decide to read proxy-voting decisions that appear to side consistently with ESG. Regardless, HFSC will call big banks and asset managers up for a drubbing on what is likely to be a reasonably-regular basis, action sure to make these companies even more assertive about the extent to which their decisions are warranted by external financial considerations, not political belief.
- Systemic Risk: Shortly before adjournment, HFSC Chairman McHenry led a letter to the Fed raising significant concerns about systemic risks in the foreign-exchange settlement arena. We expect the Fed to be closely questioned on this point when its chairman or supervisory vice chair comes before HFSC, perhaps precipitating a Fed statement or action ahead of time to show that it not only knows about this risk, but also cares enough to reduce it. Here, the Fed will need to be very, very careful because, if its counter to systemic-risk concerns is an expression of confidence in continuing central-bank swaps, Republicans will remind the Fed that many of them oppose these on the grounds that U.S. taxpayers are put at risk for other nations' profligacy.

Federal Agencies

All of the initiatives discussed below will also come before Congress for rhetorical review and, especially with regard to the CFPB, tongue-lashings that come as close to legislative action as Republicans can construct. We expect none of these fusillades to turn into federal law but note below that might change regulatory outcomes.

- **Regulatory Capital:** This issue trumps all others in terms of its bottom-line impact on banking organizations, their customers, and competitors. Early this year, the U.S. agencies will propose sweeping changes to the current risk-based and leverage framework based on Basel's end-game rules, working at the same time on Fed Vice Chairman Barr's "holistic" rewrite to bring all of the rules into better alignment for their desired [purpose](#). This review will look not only at risk-based capital, but also at the extent to which the leverage ratio is unduly binding and thus impairs market liquidity. Historically, markets change as soon as capital proposals are released, making it clear that structural change will occur far more quickly than that of actual regulatory standards. Congress will push and pull on these rules and influence specific provisions, but broad outcomes are solely up to the agencies.
- **Cryptoassets:** Nothing shows the power of capital rules as clearly as those soon to be applied to cryptoassets. These will proceed on a separate track from the broader capital rewrite because the U.S. intends to implement Basel's new capital and prudential [standards](#) and these are based on the end-game standards. Once the U.S. puts these in place, stout firewalls will go up between unregulated and high-risk digital finance and banks and the payment system to which they remain the most important portal. We do not think any crypto or stablecoin legislation will materially affect banking-agency crypto rules or SEC Chairman Gensler's enforcement-focused strategy unless new law expressly overrides them – low odds as noted above.
- **Stress Testing:** For the largest banks, all the capital rules pale before the way the Fed's stress tests calculates the extent to which they suffice at each of the nation's largest banking organizations. Mr. Barr also has a rewrite of stress-test methodology on his mind, planning to reconfigure the current stress capital-buffer [construct](#) to one based on multiple scenarios that capture the full extent of a bank's inter-connectedness. Nonbank mortgage companies might also get stress tests all their own if FHFA takes FSOC's recommendations to do so as seriously as we [expect it will](#).
- **Resolution Standards:** Another capital-critical issue surrounds the extent to which large regional banks are resolvable. In an advance notice of proposed [rulemaking](#), the Fed and FDIC have preliminarily decided that they aren't and the solution to this is higher buffers by way of lots more long-term debt and/or capital. If finalized as proposed, this cost of doing business for the largest regionals will be formidable, leading some to think twice about M&A that makes them big enough to come under this resolvability regime.
- **Merger Policy:** This has been coming soon from the Fed since 2021. At this point, we think the Fed will make case-by-case decisions, largely approving small mergers and subjecting at least one pending regional-bank one to strict restrictions or even turning it down to show that the Fed does not, as Congressional critics allege, "rubber stamp" these deals.
- **Climate Risk:** Next up here is inter-agency action on the climate risk management principles separately proposed by the [Fed](#), [OCC](#), and FDIC. None of these standards mandates stress testing with immediate capital consequences, but the biggest banks are nonetheless building out scenario analyses sure quickly to turn into the supervisory capital standards global regulators clearly [contemplate](#).

- Third-Party Relationships: In addition to the crypto kibosh, regulators are planning new standards making banks more expressly accountable for the actions of their fintech “partners,” a wide array of counterparties, and vendors. Long-pending [standards](#) will be finalized in 2023 building on the OCC’s tough stand on the true-lender [test](#) and other avenues through which nonbanks hope to access the national financial and payment system.
- Payment System: Speaking of which, FedNow is set to go at least sort-of live this year. More than a decade in the making, FedNow won’t be as functional as private real-time payment systems but it’s the Fed’s and that counts for a whole lot. Indeed, access to any part of the Fed-controlled payment system is a franchise-defining status, one the Fed still plans to accord based on factors still mostly known only to [itself](#).
- Data Rights: One of the most consequential proposals in 2022 came from the CFPB on the topic of consumer data [rights](#). The extent to which consumers dictate who has access to their information and what uses may then be made of it has the potential to realign the balance of market power between traditional banking organizations and giant tech-platform companies. The odds for the CFPB’s rule favor banks, albeit at considerable cost to plans to deploy AI and other digital-market, underwriting, and risk-control processes.
- Investment Funds: The SEC will finalize its standards for MMFs, almost surely mandating swing pricing even though most of the industry said it [didn't make sense](#). U.S. standards for open-end funds are also in the works, with the Financial Stability Oversight Council also recommending that the SEC take a hard look at collective investment vehicles. Taken together, all of these actions make bank deposits a more attractive place to hold funds seeking cash or cash-equivalent standards, but the extent to which banks will want funds remains unclear given the capital rewrite noted above, changes to interest on reserves, and broader macroeconomic considerations.

If you are unable to access any of the links above or have any questions, send us a note via INFO@FEDFIN.COM.