FedFin Daily Briefing

Thursday, March 23, 2023

OFR Study Predicts Household Gains, Banking Instability From Digital Currencies

A new OFR working paper concludes that full integration of digital currencies into the economy would reduce financial-system volatility and improve household welfare, but also increase the probability of a banking crisis. The paper analyzes "truly stable," private sector stablecoins (i.e., those that are completely backed by sovereign assets) as well as CBDC, treating issuance as “generally equivalent” in the total supply of digital currency. The authors based their results on a macroeconomic model of a financial sector in which digital currencies coexist with bank deposits and households hold both forms of liquidity. The conclusion that banking sector crisis probability increases with digital currency integration is based on model findings indicating that digital currency issuance would lead to a decline in deposit spreads, leading to deleveraging and fire sales limiting bank recapitalization. The authors also note that, while household welfare could improve despite this threat to financial stability, this depends on the degree of substitutability between deposits and digital currency. Welfare losses are predicted when digital currency is closer to a perfect substitute for deposits. The paper’s finding of declining financial system volatility is observed primarily for asset prices, which are also predicted to rise. Overall, the paper advises that frictions may limit the potential benefits of digital currencies and the optimal level of digital currency may be below that in a competitive market.

HFSC Poses Still Tougher SVB/SBNY Resolution Questions

Following tough GOP letters to the Fed and FDIC earlier this week, HFSC Chairman McHenry (R-NC) and Subcommittee Chair Hill (R-AR) last night sent even sterner missives to Chairman Gruenberg and Secretary Yellen. Mr. Gruenberg is asked for supervisory and enforcement communications between the FDIC and Signature Bank even though the Fed and New York State were its primary supervisors and the FDIC may well have had no inkling of Signature’s risk until shortly before its failure. However, the letter also asks Mr. Gruenberg about any communications from New York to the FDIC, seeking to know also if SBNY and/or SVB were on the FDIC’s watch list. Extensive questions are also posed on the FDIC’s efforts to dispose of both banks, probing GOP allegations that the agency refused to sell the banks to companies it believed might have led to undue concentration.

The letter to Secretary Yellen focuses on the systemic-risk exception allowing coverage of uninsured deposits on March 12, questioning in particular how Treasury communicated with the White House and whether Treasury was aware of potential bidders for one or both banks that might have averted the systemic designation and met the FDIC’s least-cost resolution requirement. The letters make still more clear that Republicans intend to look not only at policy, but also political, ramifications of recent events; answers are due by

April but questions will surely be repeated at HFSC's March 29 hearing and perhaps also by Republicans the day before in Senate Banking.

Bipartisan Push Begins For CEO Clawbacks

Ahead of its first of many hearings on the collapse of SVB and SBNY, Senate Banking Chairman Brown (D-OH) and Ranking Member Scott (R-SC) today sent letters to the former CEOs of the banks demanding that they answer for the bank failures, noting also that they will be expected to testify before the Committee if they are unable to do so next week. This public letter is clearly intended to lay pipe for bipartisan legislation advancing the reforms President Biden requested to make it easier for the FDIC to claw back executive compensation and otherwise penalize officers of failed banks following FDIC resolution.

OFR Blog: CRE, Residential Markets Pose Little Systemic Risk

Despite growing concerns about CRE and even potential systemic risk, an OFR blog post today concludes that neither the residential nor commercial real estate market poses a significant threat to the financial system. Residential-mortgage debt is found not to pose the same magnitude of risk as 2008 because the sector is much less leveraged, new originations favor GSE conventional loans, and very few borrowers are likely to experience payment shocks. However, a correction in home prices to historic levels could pose financial stability risks due to higher household leverage. The blog post also reports that declining CRE values due to interest rate hikes will damage loan performance, especially for those with the most aggressive underwriting. However, due to long term property value increases, the post downplays potential systemic impact.

Basel Stands By Its Rules, Contemplates New Supervisory Standards

The Basel Committee's release following its March 14 meeting unsurprisingly notes the bank failures preceding it just days before, but attributes them principally to poor risk management in the face of rising rates. It lays out post-GFC rules that it states continue to make banking resilient under stress, acknowledging that developments warrant monitoring and continuing policy review. Basel also noted that it now plans to review its supervisory "core principles" (see FSM Report **REFORM92**), issuing a consultation in mid-2023 which we expect will explore a range of options suggested by recent events.

The Committee also unanimously pressed for final action on end-game rules, with the unusual mention of unanimity surely intended to goose laggard nations such as the U.S. Basel also continues to work on climate-risk disclosures and implementation of recent crypto standards (see FSM Report **CRYPTO37**).

Federal Financial Analytics, Inc.
2101 LStreet, N.W. – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

GSEs Seek Public Comment on Credit Score Model Transition

The FHFA today announced that the GSEs are asking for public comment on the implementation of their updated credit score requirements. These will phase in the FICO 10T and VantageScore 4.0 credit score models and require only two credit reports from the national consumer reporting agencies. FHFA estimates that the delivery and disclosure of the additional credit scores will occur by 3Q 2024 and incorporation of the new models into pricing, capital, and other processes will be complete by 4Q 2025. In the release accompanying the announcement, FHFA Director Thompson stated that stakeholder input will be crucial to ensure a smooth transition, minimize complexity, and avoid unnecessary costs. No specific comment is sought nor is a deadline for feedback given.

Yellen Edges Closer To FDIC Backstop

Following comments earlier this week suggesting only systemic backstops and others yesterday indicating intervention only if essential, Treasury Secretary Yellen altered her Wednesday testimony to tell the House Appropriations Subcommittee that the U.S. has not only acted, but is prepared to do so again if uninsured-deposit protection is warranted. The conditions in which this might occur were again unspoken, but the Secretary's decision to add that "additional" steps are possible is clearly designed to quell continuing regional-bank market jitters and smaller-bank proposals for temporary or even permanent FDIC coverage expansions. The hearing was otherwise uneventful, focusing more on the debt ceiling than has been the case in prior sessions even though Republicans challenged the SVB/SBNY actions and Democrats applauded them in broad terms.

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.

- **GSIB21:** In this report, we assess the implications of recent events on two assumptions underlying current U.S. and global policy affecting GSIBs and those considered domestic SIBs: first, all are likely to be well insulated from illiquidity and/or insolvency and, when this is not the case, then orderly resolution without taxpayer bailout can be readily deployed.

- **LIQUIDITY33:** Among the most vexing issues in the wake of SVB's failure is the extent to which social media may have led to the first "viral run," a run akin to the meme-stock volatility that lead the SEC and others to fear a new form of "flash-crash" risk.

- **GSE-032023:** In this report, we build on FedFin's in-depth reports about recent bank failures to detail new risks for all of the innocent bystanders in the U.S. mortgage market along with a not so-innocent bystander: the Federal Home Loan Banks.

Federal Financial Analytics, Inc.
2101 LStreet, N.W. – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

- **REFORM216:** In this report, we continue our policy postmortem of SVB/SBNY and, now, so much more.
- **DEPOSITINSURANCE118:** As promised in our first post-SVB impact assessment (see *Client Report* **RESOLVE49**), this report begins a series of analyses of specific policy issues.
- **RESOLVE49:** As we noted last night, the President concurred with Treasury, the Fed, and FDIC in deciding that SVB's Friday failure and imminent runs on Signature Bank and, most likely, others posed a systemic risk.
- **GSE-030923:** As detailed in our reports earlier this week on Powell's appearance before Senate Banking and HFSC, much was said about the pending rewrite of big-bank capital standards.
- **FEDERALRESERVE73:** At today's HFSC hearing, Chairman Powell modulated his hawkish stance just a bit, continuing as he long has done to refuse to take a stand on fiscal policy while advocating for rapid debt-limit action.
- **FEDERALRESERVE72:** Although Chairman Powell's testimony kept exclusively to monetary policy, today's Senate Banking hearing seemed only to go through the motions set at previous hearings with regard to inflation, growth, and the Fed's long-term objectives.
- **GSE-030123:** A recent FRB-Atlanta study finds that closing the racial homeownership gap alone would not redress housing market racial disparities because minority homeowners cannot equitably access home equity and thus enjoy comparable access to the economic opportunities afforded by homeownership.
- **SANCTION20:** In a remarkably bipartisan session, the Senate Banking Committee today made it clear that Congress wants tougher sanctions against Russia, near-term action against hold-out nations to oil-price caps and other efforts, and perhaps even confiscation of Russian assets to fund U.S. Ukraine aid.
- **CRYPTO40:** In the wake of revelations by Silvergate and other banks about significant deposit exposures to cryptoasset entities, federal banking agencies have issued a statement about the need to manage liquidity risk associated with cryptoassets.
- **GSE-022723:** FHFA has proposed a set of refinements to the current GSE capital construct.
- **CUSTODY5:** Making full use of powers granted in the 2010 Dodd-Frank Act, the SEC is proposing a wholesale rewrite of the rules dictating how investment advisers must place assets in custody and which institutions are considered qualified for this purpose.

Federal Financial Analytics, Inc.
2101 LStreet, N.W. – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com