FedFin Daily Briefing

Thursday, April 20, 2023

Reed-Grassley Bill Lays Out Another Clawback Construct

Sens. Reed (D-RI) and Grassley (R-IA) introduced yesterday S. 1181, a bill allowing the FDIC to claw back the prior two years of failed bank executive compensation and prohibits them from working at another financial institution for at least two years. While similar to the Warren-Hawley clawback bill (see FSM Report **COMPENSATION35**), it lacks language allowing the FDIC to go after "institution-affiliated parties" and executives at still solvent institutions. The bill also bars recouped funds from being paid out of liability insurance coverage. Senate Banking Chairman Brown (D-OH) has signaled that he is working with Sen. Scott (R-SC) to craft a consensus clawback bill; when he has done so, it seems likely that legislation along the Reed-Grassley bills lines will advance.

FRB-NY Staff Find Severe Climate Risk At Big Four U.S. Banks But We Wonder

Based on a more in-depth study, a new FRB-NY post measures the market risk to financial institutions related to climate change. Using a model portfolio of exposures with significant transition risk, the study attempts to correct for problems such as the limited utility of prior climate events and the subjectivity of market judgments about bank equity sensitivity to emerging risks. The paper asserts that its methodology clears the noise and subjectivity of current climate disclosures. Assuming severe, but plausible, risk, it concludes that climate risk for the top four U.S. banks increased 47 percent when judged by market capitalization in 2020 due to the combined impact of climate risk and lower equity valuations. The authors assert that this acute risk finding is not due to Covid but rather to the sharp drop in fossil-fuel prices during 2020 and the high cost of this transition risk. We would note not only that this is a models-based result, but also that the 2020 drop in fossil-fuel prices does not appear to us to be attributable to transition risk, but rather macroeconomic shock due to the pandemic. Although the post provides some later data, it does not update the 2020 market-equity loss judgment of unrecognized climate risk.

FSB Report Shows Growing Supervisory Interest In Climate-Related Compensation Frameworks

A new FSB report on climate-related financial risk factors in compensation frameworks across the banking, insurance and asset management sectors concludes that financial institutions will need to continuously revise their climate-related criteria to ensure effective alignment of compensation with prudent risk management. The report, based on a recent FSB questionnaire and an industry workshop, highlights common cross-sector challenges including data gaps, lack of objective criteria, difficulty balancing financial and nonfinancial measures, misalignment between the timeframes for performance evaluation and the achievement of climate-related results, and ensuring broad organizational incentives beyond senior management. The report notes that key performance indicators and their link with performance evaluation and compensation outcomes is mixed and that the impact of climate-related metrics on total compensation outcomes is now relatively modest. Although the report does not provide specific guidance, it still advises that embedding climate-related financial vulnerabilities may be a potential area for stronger supervisory focus.

Brown Presses For Stringent FHLB Mission Standards

Following considerable furor over the role of the FHLBs in recent bank failures, Senate Banking Chairman Brown (D-OH) has written to FHFA Director Thompson requesting that the agency's planned FHLB report also include a detailed assessment of this issue. Specifically, Sen. Brown wants to know if System actions were consistent with safety and soundness, financial stability, and a mission described as focused solely on supporting long-term housing finance. Sen. Brown disputes System assertions that the mission also includes providing liquidity support when members experience stress, stating that it is instead only to support housing and then only at sound member institutions. Sen. Brown also wants FHFA to assess the extent to which it, the Banks, and prudential regulators communicated with specific regard to recent failures to ensure the System's best interests and financial stability. Since the FHFA has not yet indicated when its report will be released, it is unclear if its conclusions will factor into pending legislation. However, this letter is sure to focus FHFA on the extent to which it needs to revise System standards in light of recent events.

Waller Sees Promise In Tokenization, AI

Following prior comments about crypto risk, FRB Gov. Waller today highlighted two innovations he believes may well have natural use cases if their risks can be contained or mitigated. He focused on both tokenization and AI, finding that tokenization can facilitate real-time transfers and increase capital and liquidity efficiency through smart contracts. When it comes to AI, Mr. Waller highlights the potential for improved customer service, fraud monitoring, and credit underwriting. However, he also notes increasingly large and complex datasets and explainablity challenges.

Fed Study: Bank Enforcement Action Resolution Improves Minority Lending Outcomes

A new Federal Reserve paper concludes that enhancing bank loan and internal governance policies is critical to improving access to credit for minority borrowers. Using call report data as well as the S&P Global SNL Financial database to identify all bank C&D and PCA orders since 1997, the paper finds that minority lending increases significantly after banks resolve enforcement actions. Even greater effects on minority lending are observed when enforcement actions mandate improvements in lending policies and stronger internal governance over lending decisions. The authors also find that increases in minority lending are significantly higher for supervisory interventions that specify loan-policy revisions and/or require more formal internal governance procedures in counties with a higher proportion of subprime borrowers. The increase in minority lending is also greater for banks with stricter regulators and more severe actions, judged in part by the frequency of regulatory upgrades and downgrades and the length of time it takes a bank to exit an enforcement agreement. The findings are found to be causal, not simple correlations, because the enforcement actions considered in this study are not directly associated with fair-lending violations.

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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.

- **GSE-042023:** FHFA yesterday proposed a sweeping rule that would codify Sandra Thompson's equitable- and fair-housing standards in a rule that any future FHFA director would have to work a lot harder to reverse.
- **CRYPTO42:** As we anticipated, the HFSC Digital Asset Subcommittee hearing today on federal stablecoin legislation did not entertain bipartisan expressions of support for the draft noticed with the hearing announcement.
- **CRYPTO41:** As anticipated, HFSC's hearing today with Chairman Gensler was a raucous affair which, while divided sharply on party lines when it comes to Mr. Gensler, also laid out general agreement on matters such as the need for stablecoin legislation (the topic of a high-profile hearing tomorrow).
- **GSE-041323:** As we noted earlier today, global regulators are rethinking their 2015 decision not to require an express capital charge for interest-rate risk, a shift with significant implications for the role of U.S. banks as mortgage lenders and investors.
- **IRR8:** As we noted yesterday, the head of the Basel Committee has targeted two capital and liquidity compromises included in the current Basel III construct not addressed in the end-game rules to which the U.S. plans shortly to turn.
- **COMPENSATION35:** Executive compensation incentives have proved among the most important reform priorities in the wake of recent bank failures.
- **REFORM220:** In this report, we drill down on prior forecasts (see *Client Report* **REFORM219**) of near-term regulatory action to identify the revisions sure to be prioritized as NEC Director Brainard and FDIC Chairman Gruenberg seek to reverse rules finalized over their objections when they were in the minority.
- **UDAP8:** Following its usual practice of setting standards by edict, the Bureau of Consumer Financial Protection has laid out an extensive framework that brings a wide range of consumer-finance actions and inactions within the scope of enforcement sanctions governing acts or practices that are not only unfair or deceptive, but also abusive.
- **GSE-040623:** FHFA, Fannie, and Freddie yesterday updated the sometimes-controversial equitable-finance plans FHFA approved last year.
- **GSE-040323:** We have written from time to time about covered bonds.
- **REFORM219:** With Thursday's White House announcement, we know that the Administration will do its best to support Fed and FDIC efforts to color recent events as a failure of Republican-led rulemaking, not also one of agency supervisory acumen, speed, and even competence.
- **REFORM218:** Today's HFSC hearing on recent bank failures was more partisan than yesterday's Senate Banking session (see *Client Report* **REFORM217**).
- **REFORM217:** Today's Senate Banking hearing was extremely well-attended by Senators on both sides

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of the aisle clearly looking first to understand what precipitated recent bank failures, who is to blame, and what should be done next.

- **RESOLVE50:** As noted yesterday, the FDIC's recent rescues have had several unusual features with implications not only for future policy, but also for pending special assessments to replenish the DIF for the $22.5 billion estimated costs to the Deposit Insurance Fund.

- **RESCUE79:** Recent editorials and other media have often said that the FRB and/or FDIC have powers or taken actions that is not the factual case as we understand it.

- **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.

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