FedFin Daily Briefing

Tuesday, April 25, 2023

Stablecoin 2.0 Is Controversial 3.0

Ahead of Thursday's stablecoin hearing, HFSC Republicans late yesterday released a second discussion draft of legislation that received a most equivocal response at last week's subcommittee hearing (see *Client Report* **CRYPTO42**). This bill has reportedly not yet been shared with Democrats and contains provisions sure to prove non-starters if not also deal-killers. For example, it would deny the SEC authority to consider stablecoins as securities, essentially siding with several issuers and exchanges now embroiled in Commission enforcement actions (see *Client Report* **CRYPTO41**). The bill is likely also to be opposed by banking organizations and consumer groups concerned that nonbank issuers under state regulation would have significant arbitrage opportunities despite provisions in the bill that give the Fed limited preemptive authority. As before, the bill defines permissible reserve assets and mandates transparency and audit requirements, now including a CEO/CFO attestation, but it also requires tailoring to issuer size – a requirement that has become considerably more controversial since SVB that is sure to stoke additional opposition. The bill does not address ongoing concerns about qualified custodians in the wake of a recent SEC proposal (see FSM Report **CUSTODY5**), with HFSC GOP leadership apparently planning to consider this in a second crypto bill planned shortly to address jurisdictional boundaries between the SEC, CFTC, and banking agencies. We will monitor Thursday's hearing and provide clients with an in-depth analysis thereafter along with continuing to analyze iterations of possible stablecoin legislation. At this point it seems unlikely to pass even if some variation of this discussion draft advances in the House.

Treasury Finds Profitability to Blame for De-Risking

Treasury today released its 2023 De-Risking Report, finding that profitability principally explains why financial institutions choose to de-risk. Although profitability is of course adversely affected by AML compliance, the overarching impact of profitability in this sector refutes longstanding assertions that unduly harsh AML rules are the reason key communities and even countries have difficulty obtaining financing. Treasury also finds that de-risking poses the greatest challenges to money servicing businesses, non-profits, and foreign financial institutions with low correspondent banking transaction volumes. The report notes that policymakers have limited authority to address the business decisions of financial institutions, instead offering policy recommendations that may facilitate a reduction of de-risking. These include providing consistent supervisory expectations, considering requiring financial institutions to maintain risk-based AML/CFT programs, assessing the benefits and risks of emerging technologies, and calibrating sanctions to mitigate unintended economic and political consequences. Treasury also recommends bolstering international cooperation, promoting creative solutions such as regional consolidation projects, and providing technical assistance to international financial institutions.

OFR: No Single Factor To Blame For 2019 Repo Spike

A new OFR paper on the September 2019 repo rate spike concludes that while a confluence of factors – large Treasury issuances, corporate tax deadlines, and lower levels of reserves – caused the crisis, none of them individually would have been disruptive enough to trigger the spike, although limited transparency and market segmentation exacerbated it. As a result, the OFR paper may refute assertions that undue capital requirements on central-bank deposits contributed to the crisis; while a factor, this finding says it was not decisive. The authors also argue that a multiyear low in reserves would not have been sufficient to trigger a repo spike, pointing out that there were several days in the Fed's tightening cycle when reserves were at similarly low levels but no spike occurred. In the same vein, funding pressures resulting from MMF cash shortages are also said not to explain the spike given that there were other dates when similarly high pressure existed but rates did not spike. The paper also considers additional contributing factors, including increased demand for reserves by banks due to the LCR and RLAP, which the authors also argue may have reduced flexibility to internally source funds. The spike dates also coincided between two GSE "float periods," which may have reduced the availability of cash in repo markets. An increase in sponsored borrowing by hedge funds is said to be too minor to have significantly contributed to the spike.

Federal Agencies Launch New Anti-AI Enforcement Effort

The FTC, the Civil Rights Division of the DoJ, CFPB, and EEOC today released a joint statement pledging to enforce all relevant consumer protection, anti-discrimination, and fair competition laws not only on AI, but indeed also on all "automated systems" that the agencies believe to be within their jurisdictions. The agencies target unrepresentative datasets, opaque models, and developers failing to understand how their customers will use their automated system as potential factors that may lead automated systems to make unlawful decisions. In remarks today, CFPB Director Chopra also stated that unchecked AI poses a threat to civil rights, reiterating the need to combat discrimination stemming from digital redlining and black-box algorithms. He also said the CFPB has prioritized these concerns, citing recent rules re targeted marketing (see FSM Report **FINTECH30**) and credit underwriting (see FSM Report **FAIRLEND11**).

HFSC Digital Assets Hearing Set For Jurisdictional Debate

Ahead of Thursday's hearing on the latest stablecoin discussing draft, HFSC's staff memo today reiterates GOP opposition to the SEC's jurisdictional arguments. Assessing the *Howey* test, the memo concludes that digital assets may not be securities on grounds that their functional use negates expectations of profit and that they are sufficiently decentralized. Instead, SEC regulations governing digital-asset registration are said to require evaluation and enhancement. However, the memo reaffirms CFTC jurisdiction over virtual currencies or digital commodities, with these statements germane not only to the pending bill, but also the panel's plans for broader legislation realigning digital-asset jurisdiction among key federal agencies. The memo mentions no specific legislation, but lays out the need for federal action based on emerging international digital asset frameworks and the threat of crypto companies moving offshore.

ONRRP Revised

The Federal Reserve Bank of New York today revised the terms of access to the overnight reverse-repo program, adding financial stability and bank safety-and-soundness to monetary-policy implementation as ONRRP criteria for eligible counterparties or actions. It is unclear if this shift is intended to limit the extent to which MMFs or other nonbank counterparties rely on the ONRRP instead of improving organic liquidity or, conversely, if troubled banks could make use of the window to obtain overnight liquidity from the Fed without asset sales or the costs of the bank term funding program established after SVB/SBNY failures in March. Further, any firm the FRB-NY

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thinks is organized solely to use the ONRRP would become ineligible, a shift aimed at SEC-registered 2a-7 funds organized for a single beneficial owner or otherwise to access the ONRRP.

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

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