FedFin Daily Briefing

Thursday, May 11, 2023

Treasury Presses Fed Efforts to Contain Systemic Liquidity Risk

In remarks today, Treasury Under-Secretary Nellie Liang addressed systemic liquidity risks such as the 2020 dash-for-cash and recent bank failures. Treasury is cautiously optimistic about increasing regional-bank stability, but systemic liquidity risk is now structural. Treasury is thus working with U.S. and global regulators to address MMF and OEF liquidity risk and undertake new efforts to address bank liquidity and duration risk. Citing the Fed's SVB report (see *Client Report* **REFORM221**), Ms. Liang highlighted Treasury's focused on efforts to combat viral runs, better interest-rate risk management, and more effective stress testing. Ms. Liang also noted the FDIC's proposed approach to deposit-insurance reform, but said only that Treasury is looking forward to working with the FDIC to consider this question.

FDIC Proposes Special, Costly Uninsured-Deposit Assessment

The FDIC today voted 3-2 to propose the special assessments presaged in Chairman Gruenberg's Congressional testimony after SVB and SBNY's failures (see *Client Report* **REFORM218**). Notably, the assessment does not also cover the $13 billion of cost estimated for the FRC rescue in conjunction with JPMorgan's purchase; its rescue was not technically systemic and its cost will thus be covered as the FDIC reviews DIF ratios in coming meetings at which more broadly-shared, traditional premiums are likely also to increase. We will shortly provide clients with an in-depth analysis of the proposed special assessment. It is likely to be strongly criticized by Congressional Republicans on grounds cited by Vice Chairman Hill in his statement opposing the proposal – i.e., that setting the assessment on uninsured deposits rewards the biggest banks that received the largest deposit inflows, with five unnamed banks reportedly paying fifty percent of the new assessment. These banks would clearly absorb significant costs related to the new assessment, which the FDIC says would increase DIF premiums by 12.5 basis points for covered banks when they are implemented over eight quarters starting in 2024.

GOP board member McKernan also voted against the proposal on grounds that it should be more nuanced so that the banks that relied on the greatest share of uninsured deposits – not just who have the largest uninsured-deposit bases – should pay for the assessment along with banks under-capitalized in terms of their unrealized losses. Mr. McKernan also opposed what he calls the assumption in the proposal that the FDIC should step in to prevent uninsured-depositor losses in emergency situations. Chairman Gruenberg, Acting Comptroller Hsu, and CFPB Director Chopra all supported the proposal. FedFin's in-depth analysis will cover not just near-term costs, but also the structural implications of this special assessment. We conclude initially that, combined with higher overall DIF premiums, the charges create a strong disincentive for banks to attract deposits rather than rely on other products, an incentive likely contributing to the growth of MMFs and OEFs as well as greater use of the ONRRP. However, the proposal includes an exemption for banks with uninsured deposits of less than $5 billion, with comments due sixty days after publication in the *Federal Register*.

GOP Endorses GAO Recommendations; Dems Point To Bank Management

At today's HFSC Oversight Subcommittee hearing on the GAO's report (see Client Report **REFORM223**), Subcommittee Chair Huizenga (R-MI) built the case that the Fed has historically been unable to properly supervise troubled banks and noted that the committee will investigate this along with the Systemic-Risk Exception used in recent failures. Subcommittee Ranking Member Green (D-TX) emphasized that supervision was not the root cause of the failures and that Trump-era deregulation allowed mismanagement to fester. Full Committee Ranking Member Waters (D-CA) also emphasized management culpability, reiterating the call for compensation clawbacks. GAO Director of Financial Markets and Community

Investment Michael Clements largely reiterated the failures' timeline, repeating GAO's recommendation for trigger mechanisms in revised PCA standards. The hearing was largely hijacked by the debt ceiling crisis, with GOP on-topic questioning focused on the Fed's reluctance to escalate its risk management concerns. Democrats were most interested in keeping the blame focused on bank mismanagement and holding failed bank executives accountable.

Rep. Rose (R-TN) voiced concern that the FDIC capping its potential gains on selling SVB's bridge bank incentivizes purchasing banks to wait until a troubled bank goes into conservatorship to get a better deal. He also asked the director if he would commit to reviewing FSOC's actions during the bank failures; Mr. Clements stated that there is already ongoing work but reminded Mr. Rose that FSOC's recommendations are nonbinding.

Waller Disavows Fed Climate-Risk Action

Confirming the Fed's omission of climate risk in its new financial-stability report (see *Client Report* **SYSTEMIC96**), Gov. Waller today said not only is climate risk not now a threat to financial stability, but it also does not pose a safety-and-soundness hazard to large banks. He thus contradicts not only FSOC conclusions (see *Client Report* **GREEN11**), but also the Fed's proposed risk-management principles (see FSM Report **CLIMATE15**). Further, Mr. Waller fears that an undue focus on climate risk may "crowd out" attention to others, thus implicitly endorsing GOP statements that the San Francisco Fed and others at the central bank were too distracted by political agendas – their term, not Mr. Waller's – to ensure SVB's soundness. While calling for additional study, Mr. Waller's talk lays out why he does not believe that climate risk is structurally different from other financial risks, noting for example that neither physical nor transition risk pose special analytical characteristics apart from those already captured in Fed stress tests.

FRB-NY Data Contradict Story Of Significant Small-Bank Deposit Outflows

The FDIC's decision earlier today to propose new DIF assessments for uninsured deposits makes a new FRB-NY post on bank funding still more germane. Looking at funding from the onset of tightening in March of 2022 to the beginning of March 2023 before the bank failures, the study finds first that banks replaced approximately $500 billion of deposit funding with $800 billion from other sources, with these numbers not reflecting the $450 billion of deposits that left the banking system in March following bank failures. Looking at these data heterogeneously, the study finds that deposit losses were largely concentrated at large banks before mid-March of 2023, with small banks losing no deposit funding. During and after the SVB run, deposit outflows are concentrated not in the community banks that have often cited this risk, but rather at super-regionals (designated as banks between $50 and $250 billion). Further, these run-related outflows largely reversed by the end of March, with banks holding less than $100 billion generally unaffected throughout this turbulent period. The study also looks at precautionary funding, finding little offset to deposit outflows prior to the March failures and significant increases in FHLB advances and Fed-window draws after mid-March by all but the smallest banks.

HFSC GOP Demands SEC Rescind Custody Proposal

HFSC GOP leadership today sent a letter to the SEC demanding that it rescind its custody proposal (see FSM Report CUSTODY5) on grounds that the proposal is far broader than SEC authority allows, will adversely affect many markets, and make digital asset custody "extremely onerous and costly." As we noted in our in-depth analysis, the proposal assumes that staff bulletin 121 remains unchanged, with the GOP letter arguing that this will discourage bank custodial services and encourage digital-asset holders to move assets outside the regulatory system, minimizing consumer protections. The letter also states that the proposal lacks statutorily mandated economic analysis. As noted yesterday (see Client Report CRYPTO43) pending GOP efforts to harmonize securities and commodities crypto regulation are also intended to force the SEC to change this rule and staff bulletin.

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.

- **CRYPTO43**: Today's joint HFSC-House Ag hearing on assessing crypto's regulatory gaps saw bipartisan calls for Congressional action, but none on what that should be.
- **GSE-050923**: As our in-depth report earlier today details, the Fed's latest financial-stability report pulls a lot of punches because, as always, it's afraid to frighten the children with frank discussion of what might actually threaten financial stability in the near term.
- **SYSTEMIC96**: Perhaps because its last financial-stability report (see *Client Report* **SYSTEMIC94**) was contradicted just five months later by a systemic-risk designation, the Federal Reserve's latest report eschews a conclusion about prospective risk in favor of a review of current concerns.
- **SIFI35**: In concert with proposing a new systemic-risk methodology, the Financial Stability Oversight Council sought comment on guidance that significantly rewrites the manner in which nonbanks are designated as systemically important financial institutions (SIFIs).
- **DEPOSITINSURANCE119**: In this report, we follow our initial assessment of the FDIC's deposit-insurance reform report with an in-depth analysis of its recommendations and their prospects.
- **REFORM223**: Following our analyses of the Fed's report on SVB (see Client Report REFORM221) and the FDIC's on SBNY (see Client Report REFORM222), we turn now to one from the General Accountability Office sure to have at least as much impact on bipartisan consideration of what needs next to be done to govern regional banks.
- **REFORM222**: In this report, we build on our assessment earlier today of the Fed's SVB autopsy (see Client Report REFORM221) with an assessment of the FDIC's self-review of Signature's failure.
- **REFORM221**: In this and subsequent reports, we build on our initial reactions to SVB/SBNY reports from the Fed, FDIC, and GAO, focusing in more depth on the agencies' plans for near-term action with strategic consequence and key points in the GAO's report that will strongly influence Hill reactions on both sides of the aisle.
- **GSE-042723:** FSOC's newly-proposed analytical methodology for systemic risk identification is most immediately important for nonbank mortgage companies and the regulated institutions that love them.
- **SYSTEMIC95:** Rejecting the Trump Administration's hands-off approach to designating systemically-important nonbank financial institutions or activities and practices, the Biden Administration's FSOC has bifurcated this construct with one proposal on designating entities and another that lays out an analytical approach to identifying systemic risk that would then guide firm and activity designation as well as Council staff coordination with primary federal regulators leading to new rules, product or service prohibitions/restrictions, or firm-specific supervisory action.
- **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.

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

- **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.

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