FedFin Daily Briefing

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Fed Study Validates Bank/Shadow-Bank Interconnections, Systemic Risk

A new study by staff from the Federal Reserve Banks of Boston and New York evaluates the banking-sector impact of fire sales across multiple NBFI segments, finding numerous bank vulnerabilities to nonbanks not only through direct exposures, but also through complex, indirect channels. These inter-connections are a top concern of the Financial Stability Oversight Council, which targeted them in its most recent systemic methodology (see FSM Report **SIFI35**) and is likely to use this roadmap for future actions when its new framework is finalized. The paper classifies bank-NBFI interconnections into first-round, direct and second-round, indirect transmission channels. Second-round effects amplify shocks associated with fire sales many orders of magnitude beyond the initial shock, leading the authors to conclude that conventional assessments of fire-sale vulnerabilities can be grossly understated. The paper thus looks at specific segments even though it argues that nonbanks should be treated homogeneously for purposes of financial-stability consideration. Using aggregate, segment-specific information from the Fed's quarterly Flow of Funds data from 2007 to 2021, the paper analyzes twelve entity and eight asset types. In terms of first-round effects, the top-rated nonbank sectors from a systemic-risk perspective are finance companies and life insurers, followed by bond mutual funds, hedge funds, and pension funds. In terms of second-round transmission channels, bond and equity mutual funds are found to have the largest overall spillovers to banks, followed by pension funds, life insurers and ETFs. These data do not appear to support FSOC's priority focus on nonbank mortgage companies along with hedge funds as top nonbank systemic risks, but methodological issues – e.g., failure to consider spillovers to entities that are not banks such as the GSEs – may account for this at least with regard to mortgage companies.

McHenry Protests U.S. Outbound-Investment Constraints

HFSC Chairman McHenry (R-NC) sent a letter to Secretary Yellen late Friday demanding information about a potential executive order that would enable CFIUS to prohibit or require notification of outbound investments into China, stating that the Administration's interest in capital controls necessitates Congressional oversight. The chairman claims that outbound-investment restrictions on Russia in 2014 failed to deter aggression against Ukraine, arguing that any such restrictions would face the same fate in China. He also disputes the Administration's assertion that US investments in early-stage Chinese companies may require a national emergency declaration, stating that most investments have been in later-stage companies and that venture capital deals in China have sharply declined. Without a deadline, Treasury is asked to list U.S. technologies that would be prohibited, the proportion of venture capital funding that supported Chinese technologies, and – in the event that a national emergency is justified – whether Treasury would endorse secondary sanctions against third-country investments.

IMF Article Calls SVB Resolution "Riskless Capitalism"

An article in the IMF's forthcoming Finance and Development magazine issue argues that SVB's uninsured depositors enjoyed "riskless capitalism," concluding that high moral hazard-risks will persist without incentives for depositor due diligence. Written by University of Chicago Economists Raghuram Rajan and Luis Zingales, the article also argues that a ten percent haircut would have better served the banking system than the systemic-risk exception invoked to stem contagion risk. The article suggests that this haircut would have saved the FDIC $20 billion in resolution costs, an erroneous assumption in our view given the manner in which the FDIC calculates likely cost and its opportunity to have reduced these by alternative bridge-bank resolution tactics. The article also states that strong banking-industry lobbying combined with vested interests from political figures such as California Governor Gavin Newsom – whom the article asserts had private businesses with large SVB deposits – may have influenced regulators' March 12 decision. It thus argues for new regulatory means to reduce political clout, highlighting gaps in the existing antitrust framework even though it is unclear to us how these would or could affect FDIC resolution decisions under stress. The article also argues that international competition between different "systems" would highlight cronyism and inefficiencies not exposed in trade relationships between systems of "similar values" – such as the US, Germany, and UK – though this point is not developed. Still, the article's conclusions are aligned with some Republican criticism of recent Fed and FDIC decisions and may thus get considerable attention.

FTC Demands Greater Debit-Card Data Access

The FTC today finalized a consent order requiring Mastercard to provide competing card networks with the customer account information necessary to process debit payments, alleging that the company illegally withheld that information to prevent merchants from using its competitors or Mastercard-branded debit cards saved in e-wallets outside of traditional networks. It also broadly bars Mastercard from any action that inhibits merchant ability to choose between networks. The FTC alleges that this tactic violated the Durbin Amendment (see FSM Report **CONSUMER14**), reflecting also a controversial FRB rule dealing directly with network selection related to non-physical payments (see FSM Report **INTERCHANGE11**).

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.

- **SUPERVISION2:** Following a speech earlier this year by the Acting Comptroller arguing that some banks are "too big to manage" and the furor caused by recent failures, the OCC has significantly revised its enforcement policy.
- **GSE-052323:** Today's HFSC hearing with Sandra Thompson was the anti-LLPA event we anticipated when it came to Republicans that also saw the stout defense Democrats were sure to provide combined with FHFA's resolute stand on doing nothing to change the LLPAs or guarantee-fees beyond what might come of the pending RFI.
- **REFORM226:** Describing the CEOs' statements at his last hearing as "the dog-ate-my-homework" excuses for grievous failings, Senate Banking Committee Chairman Brown (D-OH) also attacked Republicans for placing blame on monetary policy, not the culture of supervisory laxity he details with various quotes from Trump Administration officials.
- **CRYPTO44:** Although there were still considerable party-line differences of opinion on stablecoin legislation, today's HFSC Digital-Assets Subcommittee hearing suggests that remaining divides are narrowing, increasing the odds of a new federal-regulatory framework.
- **GSE-051723:** With Republicans on the anti-LLPA warpath, FHFA is hoping to preserve as much of the current fee structure as possible without paying too high a political price, issuing a request for information (RFI) in hopes that letter-writing will keep everyone busy until Congress moves on to other matters.
- **REFORM225:** A joint hearing today of HFSC's Financial Institutions and Oversight Subcommittees expanded on themes at yesterday's full Committee session with bank regulators (see *Client Report* **REFORM224**) and Senate Banking's session with SVB's and SBNY's CEOs, with First

Republic's CEO now added to the Congressional firing line.

- **REFORM224:** In their first appearance following the reports on recent failures, FRB Vice Chairman Barr and FDIC Chairman Gruenberg were harshly criticized by Republicans for both the bank failures and recommended remedies.

- **DEPOSITINSURANCE120:** As the law requires and the FDIC Chairman promised after SVB and Signature Bank were declared systemic, the FDIC has now proposed a special assessment to compensate the Deposit Insurance Fund (DIF) for the cost of backing the two banks' uninsured deposits.

- **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 done.

- **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.

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