FedFin Daily Briefing

Thursday, July 27, 2023

FSB Tries to Calm CoCo Confusion

Doubtless responding to the CoCo chaos when Credit Suisse failed, the FSB today issued a report laying out how cross-border crisis-management groups are to handle unallocated TLAC (UTLAC) such as the "alternative Tier 1" bonds popular in the EU. These generally do not count as TLAC under final U.S. rules (see FSM Report **TLAC6**) nor does the proposal to impose TLAC on large regional banks do so (see FSM Report **RESOLVE48**). The U.S. regime also does not expressly include the "internal" TLAC laid out by FSB (see FSM Report **TLAC8**), complicating U.S. adherence to the FSB UTLAC resolution protocol. As the FSB now notes, effective resolutions and especially those across borders – cannot proceed without current UTLAC information on funds available at a parent level as well as those internally allocated that can be deployed to reduce capital shortfalls ahead of or in the course of resolution. To assist this, the report not only lays out the importance of mapping UTLAC, but also operational, legal, and other issues that may complicate host-country access and thus further impair speedy resolution without resort to taxpayer funds.

FDIC 3-2 Vote Presages Knock-Down Basel Battle

As anticipated, the FDIC today voted 3-2 to issue a sweeping rewrite of U.S. regulatory capital requirements. We will shortly provide clients with an analysis of the Fed's meeting later today and then proceed to in-depth assessments of the new structure. Key to FDIC Chair Gruenberg's defense of the rules as well as that of Acting Comptroller Hsu and CFPB Director Chopra is the vital importance of robust capital, model vulnerability, the lengthy transition, and the fact that – as the regulators calculate it – only five of the very largest BHCs cannot now meet the new rules. Vice Chairman Hill was scathing in his criticism, noting for example that most regional banks have minimal market-risk exposure, meaning that the burden of new rules will be highly problematic if resulting capital does not prove problematic. Mr. Hill and Director McKernan also criticized the underlying Basel framework, at the same time questioning the U.S. gold-plating and the need for such highly-sensitive RWAs. They also lambasted the operational-risk rule, noting that the business-indicator approach overlooks proven sources of operational risk and that Basel's final standards depart from the proposed approach in inexplicable ways given expert advice on issues such as the scaling factor. Their support for less-prescriptive risk weightings is a defense of the advanced approach, which not only no longer applies to credit risk as we anticipated, but is also struck from the market-risk standards. Mr. McKernan also protested the U.S. decision to hike Basel's mortgage RWAs, noting that the rationale for doing so – ensuring that big banks had no capital advantages over smaller ones – could be achieved by lowering small-bank ratios to the global approach. Although Mr. Chopra defended the proposal, he agreed with the GOP dissenters on risk weightings but for very different reasons; he echoed the FDIC's longstanding preference for a binding leverage ratio.

Divided, Cautious Fed Advances End-Game, GSIB Rewrites

As anticipated, Gov. Bowman today voted against the new capital framework, as did Gov. Waller; as a result, the vote was 4-2. While Chair Powell voted in favor of the proposal, he carefully hedged his support, making clear that he has yet to decide whether he will support anything akin to the proposal in final form. His principal concerns are calibration (with particular regard to market and operational risk), cost, shadow-bank impact, the need for gold-plating (especially with regard to eliminating market and operational models), and "striking the right balance" between capital standards and supervision – an over-arching concern that leaves open many options in terms of answering near-term Congressional questioning and formulating the final rule. Vice Chair Barr defended the proposal, asking the staff during Q&A to address one of Gov. Bowman's questions: the extent to which the capital standards overlap and even conflict with stress testing; staff answered that each standard is distinct and aimed at different objectives, but we expect this to be a continuing concern. Credit-market impact is of course also a top issue; in answer to Gov. Jefferson, staff indicated that the aggregate impact on lending is thirty basis points and there is no evidence to suggest portfolio rebalancing. Gov. Cook asked about the manner in which U.S. and EU standards differ as well as for the rationale behind the mortgage provisions. Notably, Vice Chair Barr said he is particularly interested in comments here, buttressing our view that the U.S. rules are likely to shift to the Basel approach and apply to all banks; we will shortly provide clients with an in-depth analysis of the mortgage provisions of the proposal.

All governors agreed with the second rule approved today: revisions to the GSIB surcharge. Gov. Bowman's vote is, however, conditional on the extent to which comments support the need for gold-plating in this arena (i.e., use of the second methodology designed to capture fee-based banks). As noted earlier today, we will provide clients with in-depth analyses of both rules; comment on each is due 120 days after *Federal Register* publication.

Stablecoin Bill Advances, Compromises to Come

At a fiery HFSC markup today, Chairman McHenry (R-NC) announced that bipartisan negotiations had broken down largely due to the White House, choosing to proceed to a final package as he remains open to amendment before floor action. Ranking Member Waters (D-CA) attempted various tactics to derail or at least delay the vote, but these were effectively countered. As of this writing, no recorded vote has occurred, but we expect the bill to be reported largely – but not entirely – on party lines. The most significant Democratic concerns included lack of Fed oversight or enforcement powers over state licenses, a lack of a ban on commercial entities issuing stablecoins, and claims that the bill fosters regulatory arbitrage. Republicans supported the bill, but some remain concerned with giving novel authority to an overloaded Fed, a failure to protect commodity-based stablecoins, and commercial-firm stablecoin activities. Mr. McHenry pledged to address commodity-based coins and commercial activities, enhancing chances for successful floor action in the fall.

House Republicans Skewer Basel Rules

Hill comment so far in response to the new capital rules is sparse. Of particular note, HFSC Chairman McHenry (R-NC) made it clear that he views the banking agencies as unduly aligned with the Biden Administration, asserting as his panel marked up various bills to limit the agencies that the new capital rules "double-down" on Bidenomics. Mr. McHenry also dismissed assertions that U.S. action is necessary for international coherence on grounds that the U.S. is proposing to go far beyond the global standards. Financial Institutions Subcommittee Chairman Barr (R-KY) echoed Mr. McHenry's comments about dissonance with global standards and politicization, but he stopped short of his prior demands to haul Fed leadership in before the committee to go over the standards. Instead, he pledged to "monitor" them. That said, it is clear that Republicans in the House will join those on Senate Banking in taking every opportunity to criticize the capital proposals and, should any opportunity present itself, block them at least when it comes to implications for mid-sized banks and perhaps the industry more generally.

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.

- **CAPITAL229:** As promised, we plan in-depth coverage of the Fed and FDIC meetings tomorrow as well as of the capital rewrites they are set to propose no matter all the warning shots from Congressional Republicans.
- **MERGER12:** Building on a request for comment, the Department of Justice (DOJ) and Federal Trade Commission (FTC) have now proposed specific revisions to U.S. merger policy that significantly redirect the manner in which M&A transactions – even if only for minority positions – will be considered.
- **DEPOSITINSURANCE121:** In the wake of today's Senate Banking deposit-insurance reform hearing, it seems certain that there will be no legislation in the near term and most likely in this Congress to increase FDIC-insurance thresholds.
- **CLIMATE16:** As anticipated, Republicans continued their campaign against ESG at today's HFSC Financial Institution Subcommittee hearing on climate risks, reiterating arguments that a regulatory focus on climate risk signals financial institutions to cease lending to carbon intensive industries.
- **MMF20:** The SEC has significantly revised its proposed MMF-reform standards, eliminating a controversial swing-pricing approach to reduce first-mover advantage in favor of new redemption fees at institutional prime and tax-exempt funds.
- **GSE-071823:** Reuters is reporting today and other sources are echoing three regulatory sources saying that the impending capital rewrite will propose risk weighted assessments (RWAs) between 40 and 90%, up from the minimum 20 and 70% Basel standards.
- **GSE-071123:** As we detailed yesterday, FRB Vice Chair Barr laid out what he called a holistic view of bank capital standards that encompasses end-game rules, stress testing, post-SVB lessons, GSIB restrictions, and resolvability.
- **CAPITAL228:** FRB Vice Chairman Barr's speech today outlines near-term U.S. regulatory-capital policy, confirming our earlier assessment that a sweeping proposal will soon be released.
- **GSE-070523:** As an in-depth FedFin analysis today addresses (see FSM Report **REALESTATE25**), the banking agencies and NCUA late last week issued far-reaching guidance encouraging loan accommodations and even forbearance for troubled commercial real estate (CRE) projects, including multifamily obligations.
- **REALESTATE25:** The banking agencies and NCUA have agreed on a final policy statement providing guidance for how financial institutions are to handle troubled commercial real estate loans, giving banks considerable latitude to forbear when borrowers are unable to meet their obligations but are deemed to be able to pay at least some of it over time.
- **GSE-063023:** In non-public remarks ahead of a presentation by FedFin managing partner Karen Petrou, Sen. Jack Reed (D-RI) laid out what he thinks banking agencies will do next, doubtless based on what they've told him that they'll do next.

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