FedFin Weekly Alert

Monday, August 21, 2023

❑ Capital Regulation Deconstructed

Last week, we provided clients with several more in-depth analyses of the interagency capital proposal. Of particular note is our wrap-up report (see *Client Report* **CAPITAL234**) which looks hard at the agencies' own quantitative and qualitative impact assessments to see what the raw numbers say, how the numbers comport with current data and market realities, and – most importantly – how to interpret the agencies' qualitative conclusions in light of these analytics, as well as our understanding of many of the studies on which key assumptions are premised. As the report details, we agree that the agencies' rationale for every possible capital woe – that anything is better than a financial crisis – is right. But it's only right if the result of the rules is to make financial crises less likely and that, as our reports make clear, is far from assured. Many provisions of each key section combined with overall quantitative results could well prove profoundly destabilizing.

In addition to FedFin's impact assessment, last week saw our reports on:

- The housing-market impact of the new operational-risk rules. This is based on our in-depth assessment of the underlying operational-risk proposal (see FSM Report **OPSRISK22**), one of the areas where unintended and perverse consequences are particularly probable;

- The noted broader assessment of bank, financial-system, macroeconomic, and financial-stability consequences of the proposal as a whole (see Client Report **CAPITAL234**). This analysis goes beyond what the agencies say their rules might do to our thinking about how likely that is, what might happen instead, which of the data on which the agencies base their conclusions make sense, and whether the research the proposal cites is as supportive as all that; and

- A deep dive into the formidable implications of the market-risk provisions (see FSM Report **CAPITAL233**). As with operational risk, this is an area where perverse consequences seem particularly probable in part because key sections of the proposal do not hang together as a whole.

Headlines From the Past Week's Daily Briefings

August 14

- **FDIC Finds Banks Well-Capitalized, Resilient –** FDIC's 2023 Risk Review concludes that banks were well capitalized as of Q1 2023 and have demonstrated resilience through weaker economic conditions, rising interest rates, high inflation, and this year's financial turmoil even though industry performance moderated from 2022.

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- **FDIC Plans Major Resolution, Insurance Rewrite -** As anticipated, FDIC Chair Gruenberg's speech confirms that his agency and the Fed will soon propose a TLAC framework for regional banks akin to the long-term debt TLAC standards imposed on GSIBs (see FSM Report **RESOLVE48**).

August 15

- **HFSC GOP Accuses SEC, FINRA of Crypto-Bill Sabotage -** Accusing the SEC of preempting HFSC Republicans' crypto legislative efforts via FINRA, HFSC Chairman McHenry (R-NC) and 22 other Committee Republicans sent letters to SEC Chairman Gensler and FINRA CEO Robert Cook arguing that the timing of Prometheum Ember Capital LLC's approval to operate as a special purpose broker-dealer (SPBD) was calculated to show that the SEC's current crypto regulatory powers are sufficient.

August 16

- No news of note.

August 17

- **Fed Finally Deploys Source-of-Strength Authority -** In its first action imposing source-of-strength requirements in recent high-risk situations, the Federal Reserve issued an enforcement action against FTX-connected Farmington State Bank and its holdco, FBH Corp.

August 18

- No news of note.

This Week

Wednesday, August 23

SEC Open Meeting. [10:00 am, webcast]. Matters to be discussed: exemption for certain exchange members; private fund advisers; and documentation of registered investment adviser compliance reviews.

Future Events of Note

No meetings of note.

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.

- **CAPITAL234:** With this report, we conclude our assessment of the regulatory-capital proposal with analysis of what the sum total of the credit (see FSM Report **CAPITAL231**), operational (see FSM Report **OPSRISK22**), and market (see FSM Report **CAPITAL233**) rules could do in the real world of banks, nonbanks, foreign banks, and complex market interconnections.

- **CAPITAL233:** In this analysis, we turn to one of the costliest aspects of the proposed rewrite of U.S. regulatory-capital standards: the market-risk framework.

- **GSE-081423**: As Karen Petrou's memo today suggests, there are many reasons the new operational-risk framework proposed in the capital rewrite will not only be costly for covered banks, but also counterproductive for financial resilience.

- **CRYPTO45**: In conjunction with issuing a new supervisory policy for "novel" activities, the FRB has instituted a new process requiring non-objection letters before state member banks proceed with stablecoin or dollar-tokenization activities.

- **GSE-081023**: FHFA today released the results of the ninth stress test it's run on Fannie and Freddie since Dodd-Frank demanded this in 2010.

- **OPSRISK22:** Noting that operational risk is present at all banks due to most activities, the U.S. regulatory-capital rewrite would end the current approach to operational risk-based capital (ORBC).

- **FINTECH32:** FRB Vice Chairman Barr's assessment of SVB's failure included a commitment to pay additional supervisory attention to "novel" activities.

- **GSE-080823:** Our most recent analysis of the inter-agency capital proposal focuses on significant changes to the rules for securitization and credit-risk transfer positions.

- **CAPITAL232:** Based on our analysis of the inter-agency capital proposal's framework and its credit-risk provisions, FedFin turns now to the proposed approach to equities as well as to that for securitization exposures (i.e., those that are tranched rather than simple secondary-market issuances of packages of loans or other assets backed as needed by a single credit enhancement).

- **CAPITAL231:** In this report, we proceed from our assessment of the proposed regulatory capital framework to an analysis of the rules governing credit risk.

- **GSE-080323**: As we plow on with our in-depth analysis of the new capital proposal, we will continue to advise of key provisions in the massive rewrite with important implications for residential-mortgage finance.

- **CAPITAL230:** In this in-depth report, we begin our analysis of the 1089-page capital proposal released by the U.S. banking agencies not only to make U.S. standards more consistent with Basel's 2017 "end-game" rules, but also to correct failings in the current capital framework the agencies believed were laid bare by recent bank failures.

- **GSE-072823**: We've much more to do to determine the strategic and policy impact of the new credit-, market-, and operational-risk capital rules singly and collectively – a complex task given the 1,087-page rulemaking made harder by some extremely-arcane language that may either mask what the agencies mean or differ from what they meant to mean.

- **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

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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.

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