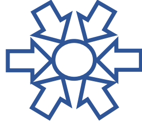

FedFin Daily Briefing

Friday, September 8, 2023

Barr Backs Away from CBDC, Stands Firm vs. Stablecoins

FRB Vice Chair Barr today for the first time sided firmly with Chair Powell in approaching CBDCs with caution, if at all. Mr. Barr also emphasized not only that the Fed will not proceed with a CBDC without Executive Branch approval, but also now says that it would require "authorizing legislation," not just Congressional "approval." Although Mr. Barr defended the new novel-activity guidance (see FSM Report **FINTECH32**) in the face of GOP criticism, he said it only reaches Fed-supervised entities. As a result, stablecoins continue to pose systemic risk in the absence of federal regulation – a position clearly intended to reiterate the Fed's opposition to the most recent version of GOP stablecoin legislation. The Vice Chair is unsurprisingly a strong FedNow supporter, but also more emphatic than Gov. Brainard about the importance of working cooperatively with private real-time payment systems to give consumers a choice of instant-payment providers within sound guardrails. Under questioning, Mr. Barr gently countered CFPB Director Chopra's jibe yesterday that the Fed lacks technically sophisticated staff.

Examining CBDC and Wholesale Payments

The FDIC today released an internal – but not necessarily independent – review of First Republic's failure, largely saying that FDIC supervisory staff could have done better identifying emerging risks without strongly criticizing actions ahead of the bank's collapse. This is blamed on factors evident at the time: e.g., rapid growth, poor liquidity and interest-rate risk management. The report itself details how the FDIC had the company under continuous supervision as befitted a bank of its size, apparently avoiding the staffing and other logistic problems identified as causes of the FDIC's failure to prevent Signature's failure (see *Client Report* **REFORM222**). Much of the report talks about how supervisors "could have done better," although the report says that supervisors would have gotten push-back from the bank due to strong earnings and capital ratios in August of 2022 when problems were identified, implying that this was ample reason for the supervisors not to force better risk mitigation. The few suggestions FDIC supervisors made in August were resisted by FRC's management and board in November of 2022 and there the matter appears to have rested. First Republic scored all outstanding and satisfactory CAMELS ratings in 2021, with the FDIC only lowering its composite rating to 3 on March 31, 2023 after the mid-March failures when FRC was already under acute stress. The report includes issues for further evaluation, reiterating those in the SBNY report and also recommending greater supervisory emphasis on unrealized loss, "explor[ing] opportunities" for greater holistic supervisory information sharing, seeing if other supervisors have difficulty learning if bank boards resist recommendations, and – most interestingly – "explor[ing]" ways to anticipate reputational risk (i.e., market-price declines, short selling, and social media).

Fed Study: CBDC Unnecessary for Successful Wholesale Tokenization

As JPMorgan and other companies continue to advance wholesale digital payments and Chair Powell has suggested (see *Client Report* **FEDERALRESERVE73**) that he may be open to wholesale CBDC, a new Fed staff study finds that tokenized wholesale payment systems do not require a new form of central-bank money. Using a theoretical model, the paper concludes that creating a new Fed liability and settlement asset is not necessary if the current wholesale payment systems are appropriately adapted to reflect the decentralized nature of DLT processing within a permission-based construct. Technology is said not to necessitate a new settlement asset because current forms of central-bank money suffice for tokenization if the overall system ensures finality and has other key payment-system stability features. In short, if the central bank continues to control the digital payment system, then it can function via master accounts and

other key payment portals regardless of digitalization even in the absence of a new form of central-bank money. The paper notes that some nations (e.g., Switzerland) allow interconnectivity between the private and central-bank payment systems that would be hard to accommodate without new risks for digital wholesale payments, but counters that this is not now done in the U.S. and would not be needed to ensure successful private-sector tokenization innovation under the central-bank umbrella. All this said, the paper observes that some situations – e.g., allowing private-sector interconnectivity and contagion risk between current and tokenized systems – pose risks that might not be addressed without a new form of central-bank money, urging that tokenization designs be considered with these issues in mind and the use of CBDC as warranted.

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.

- **LIVINGWILL22:** In conjunction with proposing a new long-term debt (LTD) requirement for categories II, III, and IV banks, the Fed and FDIC are pursuing other ways to enhance resolvability.
- **TLAC9:** Building on an advance notice of proposed rulemaking, the banking agencies have issued several proposals to enhance the resolvability of large banking organizations not covered by stringent GSIB standards.
- **GSE-083123:** As we noted yesterday, the global banking, securities, and insurance regulators who comprise the Financial Stability Board (FSB) are heading back to look again at securitization to see if the post-08 framework it crafted still works.
- **GSIB22:** As anticipated in the wake of recent bank failures, the FRB has proposed a significant revision to the current rules calculating systemic-risk scores that lead to GSIB designation.
- **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

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additional supervisory attention to “novel” activities.

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