FedFin Daily Briefing

Tuesday, November 21, 2023

BIS Study: Low-Profit GSIBs are High-Risk GSIBs

A new BIS paper assesses the systemic consequences of GSIBs with low market capitalization, an issue with immediate relevance given investor concerns about the long-term earnings impact of numerous pending rules. The methodology leads the authors to focus on price-to-book ratios (PTBRs) which are found to be directly linked to investor-predicted return on equity. Although GSIB capital requirements dramatically increased over the course of the study, there is said to be no significant impact on franchise value. We would note, however, that this is found even though bank profitability is found dramatically altering the way in which GSIBs meet new capital requirements. Low-profit GSIBs generally do so by issuing new equity and cutting risk-weighted assets, thus diluting equity and stressing profitability and resulting PTBR. The study thus finds that weaker GSIBs are likely to provoke systemic risk because market solutions that avoid bailouts are difficult to pull off. Credit Suisse is a clear case in point, but the study notes that public ownership of credit intermediaries is a feature in other nations with chronic low-profit GSIBs. The paper thus urges supervisors to press weaker GSIBs quickly to redesign their business models by for example writing off troubled loans and closing or divesting problematic activities. Some nations could also reduce impediments to cross-jurisdictional GSIB mergers to reduce over-capacity and supervisors in general could consider allowing the reinvestment of earnings in restructuring (presumably at cost to capital ratios the agencies permit) and sector-wide efforts encouraging efficiency gains from digitalization. The paper concludes that "benefits would be large as banks with profitable business models are essential for ensuring confidence in the global financial system and for providing reliable funding to the real economy."

CFTC Realigns Client-Fund Segregation Standards

The CFTC today proposed to make significant changes to client-fund segregation rules governing futures commission merchants and derivatives clearing organizations covering both how FCMs and DCOs handle client funds and the manner in which they may be deposited with banks. The proposal redefines permissible investments that must still be housed at a bank or similar entity, adding foreign sovereigns, limiting MMFs to government funds, and removing certain corporate bonds and similar instruments. LIBOR references are also finally to be deleted. The proposal also expressly bars DCOs from allocating investment losses to clients. New market-risk capital standards are proposed for permissible investments, with new rules also governing investment concentration and depository-institution reporting. All of the changes are meant to enhance segregation while improving capital efficiency with more profitable but less risky investments. Comments are due by January 17.

Basel Points to Problematic Climate-Risk Implementation

The Basel Committee today issued a "newsletter" addressing issues raised since it finalized global climate-risk management principles (see *Client Report* **CLIMATE14**), now codified for large U.S. banking organizations (see *Client Report* **CLIMATE17**). Basel continues to prioritize climate-risk management, noting that data methodologies are evolving and recommending that banks use third-party data for internal reporting when their own are under development. Supervisors told Basel that banks are also lagging when it comes to quantifying climate risk, with no progress observed on implementing capital and liquidity buffers. It remains to be seen how U.S. supervisors address climate-risk management if they concur with global supervisory qualms about comparable data impeding effective supervision, especially when it comes to newly-mandated scenario analyses.

FDIC Sets Up Special Committee to Address Widespread Concerns

In a major concession surely necessary to appease at least some in Congress and ensure continuing agency function, the FDIC board today announced formation of a special committee to be chaired by Acting Comptroller Michael Hsu and Director Jon McKernan. Akin to the kind of special committee private boards establish when questions arise about a corporate chair, the FDIC panel will include not only board members who could have had no role in problematic behavior, but also as many as three additional members likely from outside the agency. Although the announcement and Chair Gruenberg's statement make it clear that he will play no role in this new process, the board resolution referenced by Vice Chair Hill is not yet available. This will likely indicate if the inquiry already chartered from an outside law firm will form the basis of special-committee work or if yet another inquiry is planned. A timeline for the report necessary to resolve critical questions was also unclear. As Karen Petrou noted Monday, the FDIC needed to take quick action to stem internal disagreements if it hoped to remain operational; it is far less clear the extent to which all outstanding matters need to be resolved to advance pending rules not requiring FDIC concurrence.

CFPB Advances First Alternate-Disclosure Option

The CFPB today announced the first test in which lenders can experiment with consumer disclosures rather than being forced to use standard ones that may not suit a particular loan category. The approval is for an ICBA petition related to construction loans in which lenders now may use variations on standard mortgage forms. The Bureau sought comment on ICBA's approach in February. With this approval, lenders may now apply to the Bureau for authorization to use the alternative disclosure. It remains to be seen if this cautious approach facilitates widespread use of alternate disclosures, but it is possible that even limited success will lead the Bureau to reconsider underlying regulations as it states it may do in conjunction with this decision.

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.

- **DEPOSITINSURANCE122:** As the law requires and the FDIC Chairman promised after SVB and Signature Bank were declared systemic, the FDIC has finalized its proposed approach to imposing a systemic assessment to reimburse the Deposit Insurance Fund (DIF) for the resolution costs related to uninsured deposits following a systemic designation.

- **GSE-111623:** As our reports on the Senate and House hearings with bank regulators made clear, our prediction that the agencies would compromise on mortgage risk-based capital requirements will prove itself in the final standards.

- **REFORM230:** Following yesterday's Senate Banking hearing (see *Client Report* **REFORM229**), today's HFSC session with top bank regulators again highlighted growing bipartisan consternation over the unintended consequences of the agencies' capital proposal (see FSM Report **CAPITAL230**).

- **PAYMENT27:** Building on its director's longstanding focus on fintech and tech-platform companies, the CFPB has proposed to extend its supervisory reach to nonbank providers of general-use digital payments services.

- **REFORM229:** Today's Senate Banking hearing with top bank regulators showcased broad bipartisan concern over the interagency capital proposal (see FSM Report **CAPITAL230**).

- **SIFI37:** In concert with finalizing a new systemic-risk methodology, the Financial Stability Oversight Council issued guidance that significantly rewrites the manner in which nonbanks are designated as systemically important financial institutions (SIFIs), largely retaining its initial proposal.

- **SYSTEMIC98:** 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 finalized its bifurcated proposals to designate systemic entities and another laying 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.

- **GSE-110823:** Although FHFA calls its FHLB report a centenary event ahead of the System's 2032 birthday, the agency clearly plans structural substantive reform well before that milestone.

- **CLIMATE17:** The banking agencies have joined together to issue inter-agency climate-risk guidance based on proposed standards from the FDIC, OCC and FRB.

- **INTERCHANGE12:** As suggested when the Fed last year finalized controversial new debit-card routing requirements, the central bank is now proposing a sharp reduction in the cap mandated on debit-card interchange fees under the Dodd-Frank Act's Durbin Amendment for debit-card issuers with over $10 billion in assets.

- **AI3:** In this report, we assess the detailed executive order (EO) issued late Monday afternoon after days of private showings of selected versions.

- **DATA4:** Following a request for information that was a de facto advance notice of proposed rulemaking, the CFPB has now proposed a preliminary, but binding framework for consumer data rights covering consumer "transaction" accounts offered by banks, credit unions, and – a departure from the initial outline – nonbanks/fintechs.

- **GSE-102323:** As noted in our report earlier today, the Federal Reserve's latest financial-stability report expresses deep misgivings about complex securitizations.

- **SYSTEMIC97:** As promised, this in-depth report assesses Friday's semiannual financial-stability report from the Federal Reserve.

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