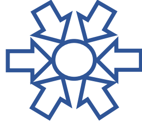

FedFin Daily Briefing

Tuesday, April 23, 2024

New Fed Study: Economic Inequality Key to Growing NBFI Role, Systemic Risk

A new Fed staff note builds on prior research to show not just the link between economic inequality and financial instability, but also how heightened systemic risk due to factors such as NBFI growth is driven by economic inequality. The study for the first time finds significant correlations between economic inequality and the growing role of nonbank asset managers, investors, and short-term wholesale lenders, observing the proven link between NBFIs and financial-system amplification. Using predictive regressions related to the top one percent's income and wealth share, the paper looks at the four systemic-risk factors targeted by the Federal Reserve as most recently done in the Fed's Friday report (see *Client Report* **SYSTEMIC99**). It shows that rising income inequality increases corporate-bond issuance and the amount of assets held by mutual funds and life insurers relative to GDP. The study for the first time also finds that income inequality strongly correlates with greater nonbank short-term funding, with the causal mechanism here and in other correlations with inequality being the growing stock of high-wealth household savings and the resulting demand for riskier assets along with over-borrowing by lower-income households and governments. The paper does not assert that these correlations are necessarily causes of financial instability due to inequality itself, but it notes that the factors that correlate to economic inequality have long been found to hike systemic hazard – the reason the Fed uses them as systemic-risk indicators. However, the strong correlation between economic inequality and core vulnerabilities and the manner in which these are heightened by the migration of financial services to nonbanks is novel and not yet incorporated into Fed thinking. Additionally, the paper confirms the analyses also presented in Karen Petrou's book linking inequality to the financial instability sparked by higher equity valuations and household leverage relative to GDP.

Asset-Manager Passivity Standards Set for Thursday Rewrite

As anticipated, the FDIC has set this Thursday as the date at which it will address concerns that index-fund and other asset managers are no longer passive investors in banking organizations and thus may warrant BHC designation. We will of course analyze the FDIC's action immediately after it is released and then provide clients with an in-depth analysis of a proposal that, depending on how far it goes, could not only bring some NBFIs within the regulatory perimeter, but also have a negative impact on banking-organization market capitalization. We do not expect the FDIC's proposal to be as sweeping as some have recommended, focusing instead on tightening asset-manager compliance with passivity commitments and developing a monitoring mechanism to ensure it. The new standard could also have a significant impact on proxy-voting outcomes.

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.

- **SYSTEMIC99:** The latest Federal Reserve financial-stability assessment continues the Fed's practice of detailing vulnerabilities without drawing bottom-line conclusions; the Board once did so, but ceased this practice after opining that the financial system's risk was "moderate" shortly before the 2020 crash.

- **MORTGAGE122**: Although there was no need for further evidence that campaign season has begun, today's Senate Banking housing hearing surely confirmed it.

- **GSE-041724**: Just as the CFPB readies its assault on cashout-refi discount fees comes FHFA's request for views on a new Freddie Mac product that would give borrowers access to their locked-up equity without a new first lien at a higher rate or a traditional home-equity second riding piggyback atop the first lien.

- **RESOLVE51**: In its first public statement since 2013 about how it would execute an SPOE resolution (see FSM Report **RESOLVE23**), the FDIC yesterday released a report Chair Gruenberg described as demonstrating the FDIC's readiness to resolve a U.S. GSIB and the process it has developed for doing so under the orderly liquidation authority (OLA) provided in the Dodd-Frank Act (see FSM Report **SYSTEMIC30**).

- **GSE-041024**: *Bloomberg* today reports that the CFPB may simply ban consumer payment for lender title insurance.

- **AML137**: Senate Banking Committee's Hearing with Deputy Secretary Adeyemo reviewed the Administration's request for additional digital asset AML/CFT authority.

- **GSE-040824**: It wasn't hard for us to forecast that, after NEC Director Brainard endorsed CFPB Director Chopra's jihad against mortgage "junk fees," that the discount points that received particular opprobrium would be moved up the priority ladder for federal restriction.

- **GSE-032924**: Following FSOC's fulminations about nonbank mortgage companies, FHFA in 2023 heightened its supervisory standards mandating GSE prudential governance of eligible seller servicers.

- **MERGER15**: Following its 2022 request for input, the FDIC has released a formal proposal that would redefine the agency's bank-merger policy into one that will make it difficult for all but the smallest and simplest transactions within its jurisdiction to have the clear prospects for approval usually necessary in non-emergency transactions, subjecting other M&A applications to protracted review with a high likelihood of denial.

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