A Unified Field Theory of Banking

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Remarks Prepared for the

Conference of Counsel
Washington, D. C.
October 9, 2014

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Thank you, Mike. It's great to be here again to lay out my thinking on not just the individual policy actions for which each of you is responsible, but also their cumulative strategic impact on the future of U.S. banking. I know it's hard to take one's eyes off each demanding, complex rule to assess their sum total impact. This is, though, our most important strategic challenge going forward – we must step back from rule-by-rule advocacy and compliance now also to focus on how the impact – intended and unintended – of all of these new requirements redefines the financial services industry and, thus, the strategy demanded now of the nation's largest banks.

The points I would like to emphasize this morning are:

- Regulators and policy-makers – even those seemingly most bent on breaking the big banks' backs—know that all of the new rules could push critical financial services to non-banks and, thus, into realms of new systemic risk. Some think risky business will largely disappear because non-banks can't do it; others think they can contain this once they finish dealing with big banks. It is critically important to understand how key business lines change as new rules come into force, looking not only at the current rulebook, but also prospectively to understand how the final framework is shaping up and, then, what this means to your bank and the industry more generally.

- This analysis must be cold-eyed and dispassionate. For your bank, this means analytics that hold market factors as equal as possible to identify regulatory and policy drivers for each of your key business lines. Who wins or loses? If your bank gives or takes critical competitive ground, what actions must be taken as quickly as possible to gain first-mover advantage getting in or out? Can offerings be redesigned to preserve profitability? Are there new customers to serve? Old ones to abandon before they walk with all of their business, not just the parts you can't do?

- Whether rules are right or wrong – and many are overdue corrections to wrong-headed risk-taking – they have bottom-line impact. We have recently taken a hard look at these costs and, just for a few new rules, they are significant. http://bit.ly/1k7kns6 If banks can't absorb these costs, then they will be forced to exit businesses for which there is often strong customer demand and profound macroeconomic need. Can non-banks fill these gaps without risk? The IMF says no http://bit.ly/1uFH6OT and, even if they can meet these needs, how much risk transfers where?

- Banks aren't the only large institutions with a stake in these answers. Can central banks conduct monetary policy if market transformation leads to acute shortages in high-quality assets? What about the liquidity of the fixed-income market on which Treasury and the housing-finance system now depend? Whither retirement savings? Will credit and liquidity disappear under stress if non-bank providers take over, creating a profound procyclical push?

As you know, global regulators are working on aspects of the non-bank framework, trying simultaneously to craft prudential rules for key sectors through firm-specific designations – the wrong approach, in my view – and the development of orderly-resolution protocols for non-banks, including those deemed financial-market utilities. The U.S., in contrast, has focused only on naming a few SIFIs – much to the consternation of many in Congress – and building out a bank-centric resolution paradigm that, even if completed before the next crisis, won't address non-banks.

When I met with you last October, I said that at least one big bank would be found wanting on the living-will "credibility criterion." As you know, I was wrong – all but one of the biggest banks flunked. One reason for this seemingly-dismal performance is that living wills must meet Title I's requirement for orderly resolution under Chapter 11 of the Bankruptcy Code, but Chapter 11 of the Code can't handle it at complex financial institutions.

One solution some at the FDIC advocate might be to get a lot less complex, but that would mean so fundamental a charter redesign as to force the largest banks out of the capital markets and to shutter many offshore operations. As the IMF study I just mentioned found, non-banks don't have the capacity to replace banks in many key activities and, even if they can, risks mount. If U.S. policy-makers want this, they should say so clearly; if they don't, they need to change the legal framework for bankruptcy resolution even as they finalize the equally-important backstop of orderly-resolution authority under Title II.

A lot of hard work here is under way that hopefully will clarify this framework and make it a plausible way to shutter big financial institutions – bank and non-bank – without taxpayer bail-out. However, to the extent you are held responsible for orderly resolution in a legal framework that makes this impossible, the shadows will grow darker far more quickly than most now think possible.

Thus, one immediate analytical and advocacy priority I suggest is pressure on U.S. and global regulators not just to complete a credible Title I resolution framework through the Bankruptcy Code in concert with a Title II one for orderly liquidation that works for each of your institutions, but also to waste no time ensuring that similar safeguards are in place for non-banks. Fears are growing about systemic risk outside big banks – MMFs, broker-dealers, and other large non-banks are top of the Fed's list. Central bankers here and in other nations are thus considering giving these big non-banks access to the discount window. If they get this without all the resolution requirements, prudential rules, macroprudential standards, and governance requirements redefining you, the shadows will enjoy a moral-hazard backstop with profound competitive consequences.

I haven't time this morning to go through a landscape of high-level regulatory drivers. You can, though, find earlier discussions of this in papers we prepared for the Federal Reserve Bank of Chicago http://bit.ly/1qaCAr8 and the OCC http://bit.ly/1qhuF5u. In our proprietary work, we've gone through each critical activity and product designated by our client to map out the regulatory landscape to determine – holding all other competitive factors as equal as possible – if banks or non-banks are advantaged vis-à-vis each other. We were initially focused on some of the "shadowy" activities already targeted by global regulators, but we found in our business-analytics that activities most dramatically affected are often core traditional financial-intermediation activities like gathering funds and making loans rather than the wild-west offerings often seen as vulnerable to non-banks.

Take, for example, the shifting landscape of corporate finance. You all know well how costly assets are on your bank's balance sheet under the new capital regime, with these costs particularly dramatic for no- or low-risk assets that now come under the supplementary and enhanced supplementary leverage charges. Some of these pressures are restructuring portfolios into riskier ones, and regulators may soon try to shut this down with uncertain implications for the asset bubble they fear in the leveraged-loan arena. If banks are the source of these originations systemic risk may be addressed; if not, not – and I think not will prove the answer. Non-banks are already showing tremendous ability to generate credit products and convert them into assets exempt from capital regulation – if they aren't doing this yet for leverage loans, they soon will.

Asset managers are, for example, ramping up new funds comprised of credit products. Transforming loans into investments moves the money, but only in good times and quite likely in many cases at long-term risk. The same goes for new P2P and crowd-sourced substitutes for small- and medium-size enterprise credit products. At the least, this transformation of credit markets is procyclical. But, it is what it is, and this poses a critical strategic challenge to each of your banks.

What about gathering funds? Each of you is, I know, watching all the new entrants and seeing how they leverage the old infrastructure into the new front end. What strikes me most about the new payment products is not just how fast some are taking off – customers don't seem to care if funds are FDIC-insured, but also how well integrated they are with lending services. Think, for example of PayPal's combination of payment products and its new venture into small-business lending. Amazon anyone? What about Walmart and its new checking account offering with a non-bank bank? Remember them? Many – think Merrill Lynch, Goldman Sachs, and Morgan Stanley – were formidable before the crisis and were forced into BHCs to survive that near-death experience. The charter is, though, still out there. The farther we get from the brink, the more potent it will prove.

In short, the basic business of banking is heading to the shadows. Not fast, but all too surely. Statistics often don't show this clearly because the biggest shifts we've found in our proprietary work are often in cherry-picked products where the regulatory drivers are already well-established and other competitive forces propel them into storm-force business drivers. Interest-rate and other market factors also dampen some key regulatory drivers.

One might thus ignore this. But, look closely and it's clear that big banks face a far different strategic landscape than the one before the crisis or the industry structure on which much planning remains premised. It isn't the same strategic landscape for each of your banks because each of them is different and must respond to unique market, culture, corporate-structure, and product demands. But, all of you do share one common charter and, thus, a common challenge: anticipate the new regulatory and policy drivers of your bank's strategic direction or let them define it. If you wait, I fear that your company will confine itself to a dwindling array of lower and lower-profit products.

Increasingly required by U.S. regulators to conduct themselves as utilities, not the profit-generators to which shareholders are accustomed, banks like yours may see investors flee in concert with customers. The utility model might not be a bad deal – it will be comfortable, if not profitable. But, if that's the end game, let's know it now, define policy accordingly with the transparency regulators demand of your banks, and give you a chance to counsel your bank to reconfigure itself into a new business model before it's too late.