Federal Financial Analytics, Inc.

Financial Framework at Risk Due to Regulatory Arbitrage, Petrou Concludes

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> "Although FSOC will debate shadow banking on Wednesday, non-banks have become potent providers across the full financial-product spectrum, including retail payments, mortgages, commercial loans, and many other services long seen as the bedrock of the financial-intermediation role for which banks are chartered, afforded special privileges, and heavily regulated. Consumer, investor, and financial-market risk is increasingly regulated judged by form – i.e., charter – not by function, creating drivers that realign financial-market product offerings based on the most favorable regulatory venue. For all the talk of 'shadow' banks, regulators have not meaningfully addressed the shift of activities from regulated banks to "shadow" firms and the risk this poses to consumers and average investors, and – under stress, to the stability of financial markets."

On Thursday, Karen Shaw Petrou, managing partner of Federal Financial Analytics, will present a paper http://www.fedfin.com/images/stories/client_reports/The%20Not-So%20Normal%20New%20-%20May%202014.pdf at the annual Federal Reserve Bank of Chicago conference arguing that, when "shadow assets" are at least 174% of those in banks, it's past time to assess the transformation of the financial competitive landscape into one in which winners and losers are increasingly determined not by competitive acumen, but rather by

the rules that govern them. Unregulated, “shadow” banks are a longstanding feature of financial markets, but the competitive challenges they pose have increased in tandem with the need for policy action because reform rules are bank-centric but products are not.

Petrou states that, “If non-banks gained their formidable edge because they’re just better at what they do than banks, so be it. But, when regulatory arbitrage is the name of the competitive game, banks aren’t the only big losers.”

Importantly, neither Petrou nor the paper disputes the need for the post-crisis reforms being imposed on the nation’s largest banks. The capital, liquidity, derivatives, and other requirements are largely warranted, but they also are what the paper calls “regulatory drivers.” That is, regardless of policy merit, these rules change the shareholder-value proposition for critical products and services. The paper analyzes business lines to see which is heading where, noting examples such as the sharp rise of non-bank mortgage lenders, the shift in payment services to firms like Facebook, the role PayPal is playing in small-business lending, and the significant impact asset managers, private-equity firms, and hedge funds play in corporate lending.

The Financial Stability Oversight Council (FSOC) has powers under Dodd-Frank detailed in Petrou’s paper to rebalance U.S. rules where systemic or consumer risk is greatest. However, it and other global regulators have been slow to deal with shadow-bank risk despite considerable talk about it.

"Bank directors and senior management have a critical obligation to shareholders to keep their companies as profitable as possible as long as possible," Petrou notes. "They can't wait for guidance, but must instead reconstruct their franchises while the policy debate continues." As a result, she urges FSOC not just to consider financial-system realignment in the abstract, but quickly to identify areas where financial-market and macroeconomic stability could be hurt by boom-bust cycles, liquidity runs, and other risks exacerbated by form – not function – financial rules.

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