Federal Financial Analytics, Inc.

Petrou Predicts Next Systemic Risk

Monday, September 22, 2014
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In remarks to be delivered later today outside Washington, Federal Financial Analytics' managing partner Karen Petrou lays out the risks she fears could threaten still-fragile financial markets. Many of these are not those seen in 2008 on which current regulatory fix-it efforts are focused. Petrou believes much in the current rulebook is warranted, but fears that this backward-looking focus and resulting regulatory complexity could lead global policy-makers to miss the next threat to financial markets and, thus, to economic growth.

"In the absence of final, credible global resolution protocols for the largest financial institutions, we are at a particularly risky policy nexus," Petrou said. "Markets expect regulators to save them if new risks emerge because the anti-bailout framework that ensures market discipline is still absent. Regulators must do what they can to end TBTF – they lack the luxury of time because new risks could force them to ratify it all over again," she continued. "This could lead to far more punitive rules far more quickly than most financial institutions now anticipate", she said.

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Petrou focuses particularly on the risks posed by the Federal Reserve's complex QE3 exit strategy, noting in this talk the systemic challenges posed by the reverse-repo facility. The FRB may well be able to manage a smooth exit, but continuing geopolitical risks – heightened of late to systemic proportions – combine with growing shortages of high-quality assets to make this a critical concern. Continued uncertainty about the balance between monetary policy and macro prudential risk is also a top priority, Petrou predicts.

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