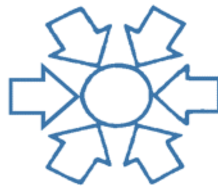
The Day the Banks Stood Still: Financial-Stability Risks from Beyond



Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.
info@fedfin.com
www.fedfin.com

Remarks Prepared for the

National Risk Committee
Office of the Comptroller of the Currency

Washington, D.C.

October 3, 2017

- U.S. banks are increasingly relegated or even disintermediated, redefining not only how financial intermediation occurs, but also where risk resides, what bank supervisors can do about it, and whether low-and-moderate income households get the financial services critical to economic opportunity.

- The traditional supervisory approach to spotting bank vulnerabilities diverts urgently-needed attention from hollowed-out bank business models. Redesigned banks may remain profitable, but they will be very different companies with very different risk profiles in concert with a restructured national financial-risk landscape. We should know what it is before we get it by default.

- Bank relegation and disintermediation are due to asymmetric regulation, legacy preoccupations, high operating costs, and perhaps most importantly to lost public trust in the value of financial regulation as a personal or institutional safeguard. Under stress, flight-to-safety epiphanies could lead to massive, sudden shifts back to banks, creating new-style financial crises possibly deadlier than 2008's.

It is a real pleasure to meet with all of you today – I have admired the OCC's leadership addressing emerging risks since you were the first of the federal regulators to spot the dangers of the U.S. subprime bubble years before it blew. More recent reports have also been the first to flag emerging risks such as HELOCs, cybersecurity and auto finance, and I commend you not only for doing this, but also for making your findings public so that national banks and the financial system more broadly have the benefit of your insights. Nothing is more counter-cyclical than seeing risk before it hits – or at least this is true if one not only sees emerging risk, but then actively does something about it.

Risk to national banks – and by inference to the rest of the banking system – comes not just from vulnerabilities within banks, but also from beyond the banking perimeter because of all the products offered by an increasingly diverse array of very effective competitors. These are powered up not only by innovation acumen, but also by regulatory arbitrage that speeds natural market evolution into headlong transformation often regardless of risk or rule.

Since the financial crisis, U.S. and global bank regulators have understandably spent enormous resources. Are fintech firms the financial market's Mad Max? Of course not. Does the changing nature of financial intermediation redefine finance and create potential risk? Indeed it does – and many fintech providers will be the first to recognize this even as they understandably seek ways around the prudential controls that hand-cuff banks to traditional business models.

The OCC is at the forefront of trying to balance the benefits of innovation with the risks of opportunism, but I think you and the other federal regulators are still moving too slowly with too few internal resources to understand the tectonic forces redefining not just banking, but also finance. Financial intermediation is breaking into component parts as non-banks cherry-pick key functions and leave what's left to banks that are increasingly relegated or disintermediated. This may seem alarmist, but IMF Managing Director Lagarde said just last Friday that the emerging shape of fintech already demonstrates power to break the fractional-banking model in place for the past few hundred years.[1]

Little-Bitty Banks?

Banks are no longer the epicenters of finance even though they remain the only financial institutions with unique taxpayer benefits, most notably FDIC insurance, access to the Fed, a source-of-strength obligation for parent companies, and all the public trust that comes with them. As I'll discuss today, the business of gathering deposits and making loans is disintermediating into one in which firms – many of them non-banks – pick the part of the financial-intermediation chain they like the best because it profits them the most. In response, banks are self-disintermediating by diversifying their offerings and finding securitization or other channels to take away risks made uneconomic by market factors or, more often, new rules.

But, when depositors, investors, and counterparties fear for the worst, funds will flood back into banks. Banks may then be ill-equipped to handle these inflows, creating liquidity freezes or other acute disruptions. In the near term, this may be because new rules require banks to save themselves ahead of the financial system; over time, it may well be because the bank business model is increasingly irrelevant to financial stability.

And, although I do not have time today to discuss this in depth, these changes also mean that, over time, monetary policy becomes still less able to ensure macroeconomic stability. Recent Federal Financial Analytics research[2] lays out how changing financial intermediation has already broken the chain between the interest-rate channel for monetary policy and many other, less conventional ones, thus making it far less effective. Even Ms. Lagarde agrees, and she thus on Friday said that fintech firms need central-bank access. That recessions do nothing good for banks or anyone else, the disconnect between financial intermediation and monetary policy is a grave, emerging risk. Financial-stability buffers such as FDIC insurance and the discount window are also predicated on an old model in which market liquidity depends on regulated banks. The less true this is, the less stable markets are absent new stabilizers such as fintech access to central-bank liquidity.

The Basel Committee's new consultation on fintech[3] sums up this problem well even as it also discusses near-term supervisory challenges to which I'll turn in a minute. Although the consultation is sadly scant on specific policy recommendations, its analysis of the rapid transformation of traditional banking is stunning.

Basel lays out five scenarios for banking based on a comprehensive landscape of retail and wholesale fintech and resulting disintermediation. In very short, these scenarios lead to:

- ***"Better Banks:"*** Here, regulated institutions become more innovative but nonetheless face heightened risk due to greater competition, more outsourcing (think Equifax), and continuing reliance on obsolete, legacy systems prone to operational risk. Perhaps what's most striking

about Basel's consultation is its pessimism about the ability of banks to be better or of supervisors to understand them if they are.

- ***"Challenger Banks:"*** These are regulated institutions that gradually displace incumbents. The OCC's special-purpose national bank charter is an example of the challenger-bank construct as are the ILCs that SoFi and Square now seek from the FDIC. As with incumbent banks, these "neo-banks" own the entire customer relationship. Most of these banks would rely on fee income, not intermediation, meaning that current rules would be far less onerous. Basel notes that none so far has gained traction, in part due to high customer-acquisition costs and aggressive pricing combined with limited product/revenue streams.
- ***"Distributed Banks:"*** Here, financial services break into modules for retail, wholesale, or payment-system products. Incumbent banks grab enough of these to sustain a profitable business model, likely using a "plug-and-play" approach in which the incumbent interfaces with fintech and other new entrants. Banks and other firms compete to own the customer, working with niche players and conceding profits as required. Financial-infrastructure services such as innovative payment-system products also come under the distributed-bank model. Supervision sustains stability here by virtue of its role over banks and authority to reach to vendors or partners. However, this approach also redefines financial-system critical infrastructure in ways supervisors are only beginning to contemplate.
- ***"Relegated Bank:"*** If you didn't like any of the options above, you surely won't care for this moniker. Here, customer relationships are owned by new intermediaries, relegating banks to the bits and pieces for which their commoditized model remains suitable (e.g., securitization), with or without retaining any balance-sheet risk. Data aggregators are an example of a new approach that relegates banks regardless of the degree to which some now agree to partner with them. Wholesale developments have also relegated banks – see for example the valuation or other services provided to asset managers.
- ***"Disintermediated Bank:"*** The last option is of course the most extreme, but it is as readily apparent across the emerging shape of finance as the "relegated bank." When customers simply bypass a bank, a bank's value as a trusted partner or the resilience of its balance sheet ceases to offer sufficient economic return for the out-competed bank. Examples already abound in both retail and wholesale finance: P2P, aspects of DLT, and leveraged loans from private-equity firms coming immediately to mind along with the full panoply of asset-management products in which investors directly buy pieces of loans generated by the asset manager or another non-bank.

The Supervisory Challenge

You all are busy with all the risks you spot at individual banks and across the system, but I fear that too much time is spent on looking in the rule-book and checking it twice at each bank and identifying problematic credit-risk categories instead of seeing the fundamental, structural transformation all around us. Like other banking agencies, the OCC has authority only so far as Congress defines it, creating significant barriers to effective, timely action that requires inter-agency coordination, cross-border harmonization, or regulatory flexibility in response to rapid-fire innovation. However, reasons why action is hard does not make action any less urgent.

The new Basel consultation is useful not only as a clear depiction of how fast and dramatically banking is changing, but also as a guide to near-term supervisory action. Some recommendations that I think warrant emphasis are:

- rapid identification of key safety-and-soundness and compliance concerns not only in terms of the broad think-pieces already well under way, but also in terms of addressing immediate gaps in the U.S. regulatory construct, areas where one regulator (e.g., the CFPB) is taking the lead without sufficient attention to prudential considerations, and where innovation from outside the U.S. has direct effect within it. Bank supervisors can't solve for all of these problems, but drawing attention to them in clear, convincing language will at the least ensure you get more resources and attention; and
- quick identification of staff and intellectual resources and expertise. Is "regtech" an option for the OCC and/or banks? The Fed is very pessimistic about this. Why? The OCC has of course established an innovation office, but I fear it is not yet sufficiently integrated into the fabric of bank supervision because innovation is still seen as esoteric. The changing business models described show clearly that it isn't.

Regulatory-Policy Decisions

Let me conclude with a few top-priority policy decisions that, even if regulatory agencies aren't authorized to make, nonetheless require urgent attention. These are:

- Can banks really become better? Basel is pessimistic, but is it time to throw in the towel? And, if it is, how much of the restructured approach to financial intermediation and financial infrastructure still requires prudential regulation to protect whose interests? In short, if banks can't do it because banks can't innovate, so be it for them and their shareholders, but what of the rest of us? And, if banks can't be better because rules make it too hard for even the best of them, do we still need all these rules given that companies outside them will come to dominate U.S. finance?
- What are the obligations of a parent company that gains access to critical taxpayer-provided benefits through a subsidiary bank, access to government-backed securitization channels, or other innovative ways around banks that can't make themselves better? Inter-affiliate transaction restrictions go only so far – that is, not very.
- How would a "distributed-bank" model work in terms not only of traditional safety-and-soundness and market integrity, but also competitiveness? Are groups of banks that band together or a few big banks engaging in partnerships with one or another big tech firm a potential antitrust problem? What transparency is needed in DLT systems or other closed groups and to whom?
- Are relegated or disintermediated banks viable long-term franchises and, if so, how much risk is left on the FDIC's or Fed's hands? If funds flood back into these shadows of the better banks that were, what happens?
- Do disintermediated banks mean that finance goes around channels critical not only for effective monetary policy, but also economic equality?

I've given a lot of thought to the economic-equality impact of the post-crisis framework for U.S. financial policy. The reason is clear: since 2008, the rich have gotten so much richer so much faster than

underlying trends would suggest that the post-crisis framework must clearly play a major, albeit unintended, role exacerbating economic inequality.[4]

Fintech and all the other financial forces redefining the basic business of banking has significant "inclusion" potential, as global regulators often recognize.[5] But, potential is not possible where profit is not probable. The blunt fact of finance is that richer people make financial companies more profitable than poorer ones unless financial services can be commoditized in ways that enhance value across the income and wealth spectrum with scale-and-scope efficiencies. A "hollowed-out" middle class combined with regulatory "penalty fees" for higher-risk products combines now to make even traditionally commoditized services such as mortgage securitization accessories to economic inequality, not engines actively engaged in enhancing opportunity and wealth accumulation

The OCC doesn't want this nor does any federal banking agency seek inequality. But changing the bank business model by way of rule – along with market innovation – changes much more than just the near-term profit perspective or risk profile at individual banks. We are in the midst of major change with profound consequence not just to finance, but also the social-welfare and economic fabric. Let's be sure we like where we're going before we get there.

---

[1] IMF Managing Director Christine Lagarde, Speech at Bank of England conference, London: Central Banking and Fintech—A Brave New World? (September 29, 2017), available at http://www.imf.org/en/News/Articles/2017/09/28/sp092917-central-banking-and-fintech-a-brave-new-world.

[2] Federal Financial Analytics, *Square Pegs and Round Holes: The Effectiveness of Monetary Policy and Macroprudential Regulation in the Post-Crisis Regulatory Regime*, May 16, 2016, at http://www.fedfin.com/info-services/issues-in-focus?task=weblink.go&id=269.

[3] Basel Committee on Banking Supervision, *Consultative Document: Sound Practices: Implications of fintech developments for banks and bank supervisors*, (August, 2017), available at http://www.bis.org/bcbs/publ/d415.pdf.

[4] See Karen Shaw Petrou, *Issue Brief: The Link Between a Smaller Fed Portfolio and Economic Equality and What the Fed Should Do About It*, (September 18, 2017), available at http://www.fedfin.com/images/stories/client_reports/Issue%20Brief-The%20Link%20Between%20a%20Smaller%20Fed%20Portfolio%20and%20Economic%20Equality.pdf; and Karen Shaw Petrou, *Economic Inequality: A Pivotal Question for Central Banks*, (May 3, 2017), available at http://www.fedfin.com/images/stories/client_reports/Policy%20Brief-Economic%20Inequality-A%20Pivotal%20Question%20for%20Central%20Banks.pdf.

[5] Dong He et al., *IMF Staff Discussion Note: Fintech and Financial Services: Initial Considerations*, (June 19, 2017), available at https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2017/06/16/Fintech-and-Financial-Services-Initial-Considerations-44985.