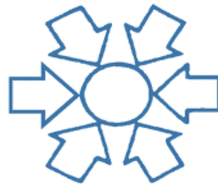
Finding Financial Footing in the New Framework: Critical Issues for Endowments and Foundations



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Key Petrou Points

- Endowments and foundations have a unique mission: profit for purpose. The emerging framework will be shaped by entities with their own interests in mind; if non-profit investors do not identify their own interests and then advocate for them, they may find critical financial services more costly, less available, and more risky.
- Ultra-accommodative monetary policy combined with post-crisis rules undermines financial intermediation, changing the financial-industry construct in concert with complicating economic recovery and widening income distribution.
- Pending changes to the regulatory framework will adversely affect custody-bank deposit-taking capacity and collateral availability, complicating if not threatening market liquidity but increasing competition for asset-management customers. Ring-fencing would deconstruct financial product offerings from large banks, redefining services across the industry for investors and counterparties.
- Newly-engineered financial instruments offer significant promise as ways for endowments and foundations to do both well and good.

It is a pleasure to join this distinguished group of multi-billion dollar endowments and charitable foundations to discuss how the financial-market changes since the great financial crisis and those soon to come affect your vital responsibilities as stewards of funding meant not for profit, but purpose. In my firm's practice, we focus on the strategic impact of financial policy – monetary and regulatory – for large financial-services firms. As a result, we look at developments such as unconventional monetary policy, capital regulation, and product constraints to identify strategic impact. Our governmental clients also ask us confidentially to tell them what we think to anticipate unintended policy impact. It's perhaps more in this latter work than our work for companies that we anticipate the impact of policies on broader markets, not just individual companies.

Today, I'd like to join both threads of this work into an assessment of what all of these policies mean to another group with vital interests in these outcomes: you and the institutions for whom you safeguard the billions of dollars entrusted to you. Your comparative advantage – the return on investment you obtain for your constituents – is only part of the challenge – you must also obtain best-value financial services, ensure that decisions reflect your fiduciary duty, and respect political or social-welfare sensitivities along the way. This requires the fancy footwork each of you does every day to anticipate the future from both a market and policy perspective. It also creates unique challenges in an ultra-low rate environment that endowments and foundations may be able to offset to some extent with creative new financial instruments designed with your mission in mind.

What I would like to do this afternoon is:

- describe the challenges facing the large financial institutions that are your providers and counterparties to give you a sense of their comparative-advantage drivers and how these affect the cost and availability of the services on which you depend;

- lay out some near-term policy issues based on the prospects for financial-industry deregulation in the U.S. and the broader global arena; and
- offer some thoughts from my service on foundation boards on innovative opportunities to meld profit and purpose.

Big-Picture Problems

Before turning to critical political and regulatory questions, let me first sketch out their macroeconomic context. I don't need to tell you that years after what many are now calling the start of the great financial crisis, U.S. rates remain ultra-low and growth is well below desired levels despite an unprecedented array of accommodative Federal Reserve policies. There are several reasons for this, not least the failure of U.S. fiscal policy to promote growth. However, monetary policy on its own must also be held accountable for persistent stagnation and ever-wider income and wealth distribution.

Each of you faces a structural challenge for as long as these macroeconomic conditions prevail, but profound though it is for you, it's nothing compared to the stress these forces put on the world's largest banks. The combination of these macroeconomic forces combines with the post-crisis rulebook to fundamentally frustrate the ability of large banks to provide financial-intermediation services that result in returns on equity satisfactory to demanding investors such as yourselves. A stunning fact – over the past couple of years, the return on equity for Britain's largest banks has been just about zero. Happily, that for large U.S. banks is better, but it's in most cases still below the big banks' cost of capital and largely derived from trading and other fee-based services.

In short, the macroeconomic and regulatory framework create strong incentives for big financial companies to play with your money, not their own to garner the fee income needed to replace that from the net interest margin on which big banks long relied. One isn't naturally inclined to shed a tear for big banks that find profits going begging, but the structural realignment in financial markets forced by their shift out of financial intermediation poses significant long-term risks. Unless or until "shadow banks" take over, the new framework has put significant barriers between savings and lending, as well as creating new risk correlations across asset classes and under different market scenarios.

My firm has done in-depth research on these questions, with a mid-2016 paper laying out the way the post-crisis rulebook undermines monetary-policy transmission. I laid this out late last year to a group of global central bankers to show also the adverse income-inequality impact of their actions, with recent work going into this in detail. An important take-away of this work is the very positive response to it from these same global central bankers and financial-policy makers. I thus urge you to lay out your own concerns to these policy-makers if you believe as I do that it's past time for the Federal Reserve to allow its $4.5 trillion portfolio to roll off and for rates to rise.

The Political Play-Book

Although my policy overview is of necessity very brief, I hope I've shown you how the financial-policy framework has frustrated both robust growth and the financial intermediation on which it depends. Financial institutions are of course not sitting idly by as their franchise value is whittled away. Many have thus focused both on trying to persuade the Federal Reserve to realign its policies and on lobbying Congress and the White House to redesign the rulebook. Much popular press talks about "Wall Street's" efforts to "gut Dodd-Frank," but the actual political landscape is far more nuanced.

Importantly, the Trump Administration has already recognized this. In addition to calling for straightforward regulatory relief for the nation's smallest banks, it is also looking at what Treasury Secretary Mnuchin has called a "21st-Century Glass-Steagall Act." I expect key details to be released in late June or so, but financial institutions are already furiously engaged in trying to craft this reform initiative to their liking.

Time doesn't permit a detailed discussion of how this new approach might work, but you can find more in a new study from my firm. Let me summarize some emerging policy-action items and how they directly affect the way you deal with your banks and financial advisers:

- Custody banks will continue to face severe limitations on accepting your deposits and those from your asset managers as long as rates remain low, the FRB swallows high-quality assets in its portfolio, and the Federal Reserve imposes a punitive capital requirement on cash and the excess reserves banks hold at central banks. You will no doubt have seen banks here decline funds or indirectly charge for them; foreign banks are even more straightforward in simply pricing deposit-taking as UBS did just a week or so ago. Challenges to earning reasonable returns on safe storehouses of your funds are thus a top-priority challenge, one exacerbated if policy-makers impose a ten percent capital requirement regardless of asset risk.
- "Ring-fencing" the largest banks is a major policy push that if implemented deconstructs financial offerings across the industry. Ring-fencing essentially means segregating traditional banking in one bullet-proof bank in a holding company and forcing asset management, capital markets, trading, and other activities into separate entities far outside the hope of any taxpayer support (they hope). The U.K. has already done this, the EU is considering it, and it's exactly what Secretary Mnuchin has in mind. A detailed description of how this might work in the U.S. can be found in the ring-fencing plan advocated by Tom Hoenig, vice chairman of the FDIC. What it means for you are still greater challenges to placing deposits, far greater emphasis on fee-based services, fewer non-sovereign assets in which to invest, and a lot more competition for your business.
- Payment, settlement, and clearing services are facing significant constraints reflected in the various flash crashes that threaten market liquidity from time to time. The new regulatory construct creates significant collateral shortages combined with costly capital requirements across the dealer-bank universe. Central clearing is gradually easing some of these bottlenecks, but also creating capital demands on the largest dealer banks that pose direct challenges to your own liquidity and trading capacity. Some policy-makers have discussed simply scrapping central-clearing mandates in the U.S.; others are looking to ease rules such as those governing margin accounts. The hot political topic at present is bank-focused regulatory relief, but don't take your eyes off the wholesale market. One near miss in it and the new regulatory framework will get the once-over from policy-makers far less inclined simply to reinforce the post-crisis regime.

I'd be happy to go into these proposals and their impact on you in more detail when I take your questions. I hope I've persuaded you at the least to think hard about the impact of these fast-moving proposals and, if they worry you, to make your voices heard – and quickly.

A New Way?

This combination of macroeconomic, regulatory, and political developments has many pitfalls despite all of our hopes for constructive reform and normalized financial policy. Hopefully, many of the risks I've outlined today will not come to pass, due in part to your effective advocacy on behalf of your constituents and their vital goals. However, as this debate continues, each of you has day-to-day responsibility for putting the funds entrusted to you to the best possible use for long-term institutional prosperity and near-term success.

Several developing financial instruments show considerable promise as ways to link profit and philanthropy. I urge you to consider these both in terms of what your endowments and foundations alone can do and what you would like Congress to authorize as it gets down to work on the public-private partnership that will underpin the nation's new infrastructure-spending plan.

Let me draw your attention to one approach I've worked hard on as a director of the Foundation Fighting Blindness (FFB). It mobilizes the profound intellectual capital of the National Eye Institute with a limited federal guarantee (constructed to eliminate taxpayer risk to the extent financial research suggests is possible) with patient, long-term institutional investors. The goal of these financial instruments is to leap over the "valley of death" between best-in-class basic science and the costly clinical trials necessary to realize treatments and cures for blindness and vision impairment.

We have structured our new bonds in a pilot program we hope Congress soon will authorize. If it works for blindness, these bond structures hold tremendous promise for uniting public resources with private capital across a wide range of threats to well-being and even life. Those of you here with a biomedical focus may want to consider how your own financial resources and knowledge could be structured into like-kind bonds that don't rely on a federal backstop.

FFB is also working with private companies to invest our philanthropic resources into research in ways designed to compensate the foundation with a market rate of return – a risk-focused one, of course, but one we think fully consistent with the foundation's fiduciary duty to those hoping for treatment and cure. Venture-philanthropy instruments also offer promise, although this has been only slowly realized outside the field of sustainable energy.

Let me conclude by emphasizing that the U.S. financial system has not been poised over so steep a policy precipice since the post-Depression regulatory rewrite and then the 2010 Dodd-Frank Act. The confluence of continuing slow growth, deep public discontent as income and wealth inequality widens, financial-market fragility, and a raft of redefining proposals poses a profound strategic challenge to each of your endowments and foundations. If you take undue risks or pay disproportionate service fees or fail to execute transactions, students will suffer and patients will be worse off. As a result, the way monetary policy normalizes and how the U.S. financial system is reconstructed makes a very big difference.

I hope each of you will find this conference helpful in formulating your thinking on these critical decision points as well as in identifying innovative ways you can serve your constituents even in the midst of all of these fast-moving developments. Deborah Prutzman has certainly chosen the right time to convene this conference in Washington, and I'm grateful to have been a part of it.