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Money Makes Markets, Not Rules: The Collision of Monetary Policy, Macroeconomic Risk, and Financial Services

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It is an honor to kick off your conference this year and set the stage for the distinguished roster of speakers Mike Bleier has again assembled. What I would like to do this morning is to put all the detailed issues you will discuss into a broader policy context that has become ever more challenging. This isn't just because each of your companies is having more and more trouble finding strategic plans that promise reasonable profits taking prudential rules into full and forward-looking account. As you all know, near-term plans that depend on cost-cutting aren't cutting it anymore as the combination of costly rules and continued low interest rates confound new-product offerings. Even if rates rise, it's at best uncertain if most banks can achieve returns on equity above their cost of capital. Old news, perhaps, but the more entrenched this strategic challenge, the greater the change in the fundamental structure of U.S. financial markets. The greater the transformation of financial markets into those in which banks don't much matter, the less effective monetary-policy transmission becomes. The less effective monetary-policy transmission, the deeper the rut into which the macroeconomy is mired, the larger the new class of TBTF financial firms, and – the most perverse result of all – the higher the risk that the U.S. financial system stumbles into another round of disastrous systemic risk.

As many of you know, the Federal Reserve for the first time last week publicly reckoned with the increasingly unavoidable unintended consequences of its post-crisis framework. At a ground-breaking conference at the Federal Reserve Bank of Boston, Vice Chairman Fischer and Reserve Bank Presidents Dudley and Rosengren joined Gov. Brainard in laying out why microprudential regulation changes markets and how powerless macroprudential regulation is to bolster them under stress. The conference follows a substantial body of work across the Federal Reserve System and in academia concluding not only that "shadow banking" has redefined financial markets and resulting risk, but also that monetary-policy transmission channels are increasingly powerless to execute the central bank's will and restore the macroeconomic growth on which financial stability most fundamentally depends. In short, we've now recognized eight years after the financial crisis that:

- When banks are tightly regulated, they don't just get safer, they also get smaller in everything but asset size. That might make some folks happy, but it leaves financial markets short of critical services and customers across the spectrum of deposit and lending products hard-pressed to get what they need. Markets also evolve for non-regulatory reasons, bringing in new players like algorithmic traders which provide services and pose risks all their own.

- When rules only circumscribe larger banks, markets don't stop changing. The thinking after the crisis that curbing big banks could control for systemic risk has now met its maker – the market. Money follows return, not rules.

- Monetary policy through both traditional channels (e.g., changing reserves or interest rates) is pushing on a string. Non-traditional, accommodative monetary policy has also proved powerless to generate robust recovery. External reality – both in the markets and that resulting from all the new rules – has collided with even the most innovative central-bank actions and made them increasingly impotent.

So, what to do? First and foremost, I urge you to work to lay out how major rules and the combination of them has altered the financial-market landscape – not to show how much this hurts your business model – been there, done that, no one much cares. If big banks get smaller, so much the better say most observers – a perspective one can more than understand given the cataclysmic damage done by the financial crisis. Now, the industry has to turn to why what's happening matters to the financial system and, most immediately, its stability. In the rest of my remarks, I'll lay out several recent case studies that do so and suggest additional ones urgently needed to persuade even the most skeptical policy-maker that it's critical quickly to rebalance policy to restore growth and ensure stability.

The Leverage Conundrum

I don't have to tell the GSIB general counsel here today how costly the enhanced supplementary leverage ratio (SLR) has proven, especially put into the CCAR context and taking into account the tough new liquidity rules. Others here may sigh with relief because SLR doesn't directly affect them, but a new FedFin study lays out at just how much risk there is for you – and the rest of the financial system – due to the structural – and wholly unintended – impact of the SLR on custody banks.

Time doesn't permit a detailed discussion of the study or its findings. What we showed is that three U.S. custody banks could hold $182 billion more in excess reserves – a number that jumps to $238 billion based on more recent data – if the leverage requirement didn't apply to excess reserves. As you all know, these excess reserves are risk-free deposits at central banks – you can't play with them, re-hypothecate them, or otherwise take risks in any of the ways the leverage ratio aims to counter. The reason the leverage charge applies is, quite simply, that excess reserves are GAAP assets and U.S. regulators feared that exempting them from the SLR would set up a slippery slope down which more low-risk assets would follow. This might or might not undermine the SLR, but it would surely expose the agencies to political ignominy.

The custody-bank problem with excess reserves arises because institutional investors want – rather reasonably – to safeguard funds in low-risk deposits. And, even if institutional investors aren't wise enough to want to take this precaution, more and more rules governing them are driving more funds into custody-bank deposits. If custody banks can't take these funds, then funds either go to shadow liabilities or asset management gets riskier. Cool.

One more problem with the unintended impact of the SLR on other people's money: it may make the U.S. even less stable in the forthcoming debt-ceiling crisis as U.S. custody banks struggle to accommodate customer deposits. And, funds that don't go to banks make it even harder for the FRB to execute monetary policy. It might have to rely still more on reverse repos, essentially making MMFs the go-to financial intermediator and rewriting U.S. finance for the foreseeable future in ways the FRB surely does not think wise.

Wrestling with Regional Bank Regulation

The leverage rule has been the third rail for industry critics since the crisis, but the track has recently gotten crowded. Joining leverage on the hot-wired list is the $50 billion threshold at which U.S. BHCs are designated for systemic regulation. In another recent FedFin study, we took a look at the unintended impact of these requirements. Again, we focused not on profitability damage – you know this, as you also know that only your shareholders feel your pain. Rather, we assessed the adverse impact of unnecessary regulation on financial intermediation around the country. We demonstrated that some of the systemic rules are indeed unnecessary, looking for example at stress-test and living-will requirements, so that we could show that added regulatory cost doesn't necessarily result in improved safety and soundness.

In short, we showed that broad-stroke systemic rules adversely affect the ability of regional BHCs to gather deposits and make loans, laying out who then would take this on and how much riskier that could make the U.S. financial system. We also detailed how higher capital requirements can lead to less private-sector capacity to handle distressed BHCs without government assistance – surely a thoroughly perverse consequence.

<u>Analytical Priorities</u>

FedFin of course isn't the only analyst on this beat. I refer you to an array of studies footnoted in our papers, as well as the work released Friday at the Boston conference. There is a raft of robust work laying out the problematic relationship between regulation, market innovation, monetary policy, and exogenous threats to financial stability on which to draw. From it, I urge you to set analytical priorities that on an urgent basis demonstrate policy and market-structure problems that undermine your strategic objectives now and – even more importantly – those to come.

You are facing two monumental challenges: perverse results from rules that curtail profitability and – perhaps even more pressing – growing obstacles to innovation that will take current competitive challenges and convert them into long-term threats to franchise value. Let me lay out just a few questions on which I think the industry needs quickly to mobilize robust analytics:

- What will happen if the FRB increasingly bypasses banks to transmit monetary policy? Will the regulatory-arbitrage incentives already evident in the market accelerate to force the FRB into potentially risky structures? Will it be forced to become a market-maker of last resort, institutionalizing TBTF – just not for banks?

- What role should interest on excess reserves (IOER) play and how might it adjust when interest rates rise? Will Congress come after IOER ($6.7 billion a year) when it realizes how much more money is there than in FRB dividends?

- Can larger banks continue to serve as critical financial-market infrastructure in the payment, settlement, and clearing system in light of the combined pressure of new technologies and less-regulated competitors? If banks exit key activities, who is served how at what risk?

- Which systemic stresses are increasingly correlated as capital, liquidity, stress-test, and other rules are implemented? What is the impact of this stress and who might be harmed by it?

- How will all the new capital charges work when taken together – i.e., standardized risk weightings for credit risk and new standardized rules for operational and trading-book risk. How will stress tests change and what risks may then result to capital planning and long-term strategy?

- Which lines of business and products are most directly affected by policy factors? Do these policy drivers adversely affect profitability based on charter and, if so, are there resulting market-stability, consumer-protection, or other adverse effects? How can these be robustly demonstrated from data that skeptics can validate?

- What will happen to bank deposit-taking capacity when rates rise? Will regulatory requirements compound structural problems and undermine the ability of banks quickly to offer competitive rates without undue NIM compression? If banks can't raise rates, will the market accept this or will the move towards "shadow liabilities" gather greater force? What actions can policy-makers take now to protect bank deposit-taking capacity and, thus, franchise competitiveness?

- Are "shadow banks" a real threat or, as many regulators believe, just a future issue to consider after finalizing the banking framework? Which lines of business are most affected by whom and what does this mean to financial stability and consumer protection?

- How will blockchain payment, settlement, and clearing systems be governed? Given the urgent focus several of your banks have placed on this emerging technology, could you actually offer it or would banks be frozen out due to fears about renewed industry collusion, the cost of capital requirements, or other barriers not applicable to new entrants? Would banks hoping to use blockchain, if not necessarily also to offer it, also be blocked by burdensome rules applied to them in lieu of the ability of regulators to reach to non-bank providers?

- Which other fintech offerings are strategically affected by current or prospective regulation? Can banks keep up? One study I've seen says banks have only three years to get their game on, but what if regulation won't let them?

Conclusion

I look forward now to discussing these questions and the others on your minds as you survey not just the policy landscape, but also your company's near-term M&A strategy and its future franchise value. Some of you may be thinking that all of these questions need urgent answers, but that policy-makers won't be swayed by any of them. I know how hard it is to get policy-makers to change course, but I know something else – the most senior of them in the U.S. and abroad are deeply worried because steps taken since the crisis are not leading down the road regulators and legislators initially mapped out.

Most policy-makers don't care about bank profitability – nor should they, as that's between you and your shareholders. They should and do, though, deeply care about macroeconomic growth and financial stability and they are getting very, very worried.

A great deal of governmental work is already under way to anticipate how new rules affect these critical considerations. Playing a part now in this analytical work will do a lot more than contribute to the sum total of human knowledge – it could actually lead to changes so far unachievable with all the formidable clout big banks are supposed to wield. Facts do matter – first, though, we have to have them.