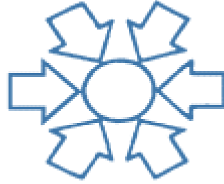

The Next Financial Crisis: How Good Rules Go Bad

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It is an honor to speak here today with Senator Gramm, a man whose name graces many of the most important banking and budgetary bills enacted during the decades he represented Texas voters – I know they miss him still. He has just spoken about the macroeconomic risks he believes result from Federal Reserve accommodative-monetary policy. But, there's an even greater danger than misfiring monetary policy: none at all. The new, radically-different structure of the U.S. financial-services market means that the Fed can't tell the economy what to do anymore because banks don't matter anywhere near as much as they used to. You may well say good riddance given the cost of the financial crisis, but a country without a functioning monetary-policy delivery channel where systemic risks increasingly arise outside the reach of prudential regulation is one putting itself at great and unnecessary risk.

Is this alarmist? I sure hope so. I'm not the only one, though, worrying a lot about the FRB's growing inability to use interest rates and bank reserves to set the economy on its preferred course – a conference held yesterday and today at the Federal Reserve Board itself on precisely this issue shows that the FRB knows it has a problem even though it has yet, sadly, to broach any solutions. The global Financial Stability Board yesterday counted up all the U.S. financial assets housed in most non-banks, logging them in at $14.2 trillion at year-end 2014.[1] That's not small and neither is the risk they pose.

Although describing the conference as a research session, Chair Yellen yesterday said that she would like to better understand how changes in the way U.S. financial intermediation affects monetary-policy transmission. Let me today offer my own thoughts on this critical question and, given how urgent it is, also a few things the FRB can and should do ASAP to save not only its ability to conduct monetary policy, but also the rest of us from preventable systemic crises.

Maybe we could manage without monetary policy if there was another way to short-circuit boom-bust crises – what we've come to call macroprudential regulation. But macropru doesn't work any better than monetary policy. In the real world in which financial institutions live or die, rules have costs and costs have consequences. Regulators believe that costs are manageable and consequences are nothing but beneficial. However, the costs now are so great that combined with other market transformations, they pose significant second-order risks. We've probably corrected for all the causes of the last crisis, but I fear we're sowing the seeds of the next one.

Where Needed Change Still Sows Systemic Seeds

Before I talk about specific regulatory actions and how they have changed the market, let me first point to one example of the best intentions that nonetheless pose grave risk. It epitomizes how even an unimpeachable policy action poses second-order dangers.

The policy actions I mean here aren't so much a single rule, but rather the cumulative impact of all of the new rules and the current, way-tough enforcement environment. Many of these rules – stress-testing, for example – are essential and punishment for crisis-causing behavior was, if anything, too weak. But in practice the new rules and enforcement regime combine with newly-enhanced risk management and better boards to force banks to devote billions not to innovation and enhanced customer service, but rather to model-building, internal investigations, and new information systems.

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[1] Financial Stability Board (FSB), *Global Shadow Banking Monitoring Report 2015* (November 2015), available at http://www.financialstabilityboard.org/wp-content/uploads/global-shadow-banking-monitoring-report-2015.pdf.

All these costs – not to mention the time management that boards devote to these critical issues – may well be warranted in theory, but these resources aren't infinite in practice. Can banks really spend the billions they need to promote cybersecurity when billions are being drained to ensure an end to compliance lapses? It's natural to delay discretionary spending when your franchise is on the line from compliance risk, but danger delayed is not danger averted. The more banks spend on risk-management infrastructure, the less they have for resilience as well as innovation, raising their operational-risk profile and giving new entrants far less careful about compliance niceties an additional competitive leg up.

Other Second-Order Effects

If I walked through the new big-bank rulebook, we'd be here from our lunch now to your dinner later. Let me thus just highlight a few of the most significant standards and the unintended consequences already evident. One reason for the deep impact of these unintended and perverse consequences is the U.S. approach to systemic regulation. Applying tough rules to bank holding companies (BHCs) with assets over the relatively tiny amount of $50 billion means that even traditional, regional BHCs are struggling with the strategic challenge I just discussed and those still to come. Here are just a few examples of good rules gone bad:

- Stress-Testing: The FRB hails this as a hallmark of the post-crisis framework and deservedly so. That tough tests make a meaningful difference is demonstrated by the strength U.S. banks regained after the strict 2009 exercise and macroeconomic growth thereafter. Tepid though it is, it's still far ahead of growth in the EU, which has of course also suffered grievous bank failures resulting in part from lax – I would call them rigged – stress tests. But, our tough tests have a significant consequence – risk correlation. As the Office of Financial Research has found,[2] this could well make individual banks safer, but lead them all to fail at once if the Fed's models miss the mark.
- Capital: This is a lot more stringent now and, again, a good thing too. However, capital isn't free – expected reductions in the cost of capital resulting from faith in big-bank safety haven't materialized because banks have to have capital and non-banks can issue equity or debt securities only when it suits them. Investors should be paying significant risk premiums for the privilege of investing in non-bank start-ups in areas such as online marketplace lending and payment services. But, pushed by desperate yield-chasing, equities and debts are flowing into all sorts of new-style financial institutions exempt from costly capital, liquidity, and prudential regulation. As a result, these companies will grow – or at least they will until they blow up. Without resilient financial buffers, non-banks simply can't function under stressed market conditions, exiting precisely at the time market stability needs them the most.
- Liquidity: Another hallmark set of rules, these require big banks to hold buckets of "high quality liquid assets" or HQLAs. This means that banks now hold lots of Treasury obligations that reduce overall market liquidity and the bank's ability to hold other assets that promote economic growth. The more HQLAs banks have to have, the fewer available for the rest of the market and the greater the fat-tail risk. Regulators have recognized this risk, but think that "collateral transformation" will solve for it – in short, they are fixing liquidity shortages

[2] Jill Cetina, *Incorporating Liquidity Shocks and Feedbacks in Bank Stress Tests* (July 2015), Office of Financial Research, available at http://financialresearch.gov/briefs/files/OFRbr-2015-06-Incorporating-Liquidity-Shocks-and-Feedbacks-in-Bank-Stress-Tests.pdf

with structured, opaque transactions with hedge funds and other non-banks.[3] These instruments didn't work out so hot the last time around and I doubt they'll fare any better if market reliance on them grows as banks are forced out. Again, market liquidity may seem sufficient as the good times roll, but then evaporate under stress because non-bank providers of collateral transformation (usually hedge funds) run for cover.

- Resolvability: Who could argue with the benefits of ensuring orderly resolution for big banks once deemed immune from failure? To deal with this, the Dodd-Frank Act demands resolution plans – often called "living wills" – from BHCs with assets over $50 billion even though Janet Yellen last week acknowledged that these may well not be necessary at the smaller end of the systemic spectrum. For the very largest banks, the new resolution requirements are far tougher and now include a requirement for total loss-absorbing capacity (TLAC) debt. For good measure, this applies to the largest foreign banks doing business here. The FRB proposal assumes all of these companies can pay up for this new buffer against taxpayer rescue. This, though, assumes that debt markets and interest rates remain unchanged from the assumptions built into the FRB's cost-benefit analysis. I doubt they will and expect also that large issuances of higher-cost debt will lead big banks to take on more risk. If they don't, they need to shrink. This might seem like a good idea if it weren't for the far less-regulated companies that will take their place.

Why This Matters

U.S. monetary policy is premised on the essential role of banks as the channels through which the FRB's will is exerted on the financial market. This comes from two channels: interest rates and reserves. Each of these assumes that the cost of funds depends on banks and that the reserves banks post with the central bank affect how much money is available for loans. Several new studies, including those presented at the FRB's conference today and a recent one from the Federal Reserve Bank of Boston,[4] demonstrate that reserve balances at the Federal Reserve are significantly distorted by new capital and liquidity requirements. Just before the crisis, banks held $2 billion[5] in excess reserves at the FRB; now they hold $2.6 trillion –not a small change and one with profound monetary-policy impact.[6]

Theory would have it that macroeconomic growth would drain excess reserves because demand for credit would grow, beating the return banks achieve by housing funds with the central bank. However, even as growth has improved, excess reserves grew. The FRB thus has not been able to reallocate reserves to growth.

This might not be as worrisome if the FRB could move market rates, but accommodative policy has lowered only the return on prudent assets like U.S. Treasuries because markets are now whirling yield-

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[3] Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), Farm Credit Administration (FCA), Federal Housing Finance Agency (FHFA), *Margin and Capital Requirements for Covered Swap Entities*, FDIC (October 2015), available at https://www.fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_final-rule.pdf

[4] Joe Peek and Eric S. Rosengren, *The Role of Banks in the Transmission of Monetary Policy* (September 9, 2013), available at http://bostonfed.org/economic/ppdp/2013/ppdp1305.pdf.

[5] FRB, *Aggregate Reserves of Depository Institutions and the Monetary Base* (September 2007), available at http://www.federalreserve.gov/releases/h3/20070927/.

[6] FRB, *Aggregate Reserves of Depository Institutions and the Monetary Base* (November 2015), available at http://www.federalreserve.gov/releases/h3/current/H3.pdf.

chasing dervishes in hopes of sustaining earnings, paying insurance claims, and hoping against hope that pension beneficiaries will enjoy the placid retirements for which they so long toiled. Unable to earn a reasonable rate on prudent assets, exempt from being forced to hold them, and unconstrained by prudential rules, investors are seeking higher-return obligations for which risk premiums are steadily falling. Treasury-market illiquidity is just one symptom of this yield-chasing – banks hold lots of safe obligations because they have to, non-bank investors go for yield, and there simply isn't enough liquidity left in the financial system to absorb shock, especially given the fact that the shocks will first be felt by non-bank investors outside the scope of Federal Reserve liquidity facilities.

How Monetary-Policy Impediments Combine with Regulatory Roadblocks to Spark Systemic Risk

Of course, the FRB might figure a way through its monetary-policy maze. Even then, though, we face significant systemic risk from unprecedented causes. If the only damage from new rules is to big banks, then we might all breathe a sigh of relief since the crisis leads many to believe that the biggest banks had it coming to them. Why, then, do all these new rules sow the seeds of the next systemic crisis?

Let's step back and identify the causes of systemic risk:

- solvency crises at the biggest financial companies on which economic growth or market function depend;
- liquidity risk that prevents counterparties from honoring their obligations and, then, creates a cascading series of defaults that lead to doom; or
- operational risk, which results from massive events like cyber-terrorism, infrastructure attacks like the one on 9/11, or a devastating collapse of internal controls.

All of the big-bank rules I mentioned earlier are meant to deal with solvency, liquidity, and operational risk, but each is premised also on two critical backstops: emergency-liquidity support from the Federal Reserve and macroprudential standards that can interrupt boom-bust cycles like the one in U.S. residential mortgages that stoked the 2008 debacle. Even more importantly, these risks now are supposed to be borne by shareholders, management, and creditors – not taxpayers.

However, if market discipline only applies to big banks and emergency backstops don't cover the broad spectrum of systemic-risk financial companies, then we've got the worst of both worlds: resilient banks subject to merciless market discipline competing against non-financial companies whose shareholders enjoy all the reward until taxpayers face risk – think Fannie and Freddie and see why implicit taxpayer backstops without explicit regulation is so deeply worrisome. We are weakening financial-market resilience, issuing lots of rules with scant regard for second-order effect, seeing monetary policy lose its punch, and finding that new rules don't make financial markets safer, they just move the game to new, untested, unregulated fields. Players on these fields not only lack capital, liquidity, and safety-and-soundness rules – they also have no access to the Federal Reserve's backstop liquidity facility. The FRB is now so frightened of it that it is contemplating becoming not just a lender of last resort, but also a market-maker of last resort – in short, a taxpayer-supported safety net for unregulated, high-flying companies without any ability to withstand stress on their own.

Perhaps we have solved for moral hazard at the biggest banks, but what of the rest of the market on which we now increasingly depend? I fear we're in for a new round of too-big-to-fail companies from which shareholders will clear out even faster with their winnings before we all pay not only for their losses, but also for our own. Without monetary policy resulting in sustained growth and normalized interest rates, these moral-hazard risks grow even larger because individuals, companies, and even countries are even less resilient. How safe and sound is that?