**The Systemic Richter Scale:**

**What Could Topple the Towers of Global Finance**

**Karen Shaw Petrou**
**Managing Partner**
**Federal Financial Analytics, Inc.**

**Remarks Prepared for the**

**American Banker Regulatory Symposium**
**Arlington, Virginia**

**September 22, 2014**

info@fedfin.com
www.fedfin.com

It’s a great pleasure to join this conference to talk about the real-world events that challenge the regulatory and resolution framework still being constructed four-plus years after the enactment of the Dodd-Frank Act. I worry very much that we don’t have the luxury of time to get all the rules as right as every interested party sees it. Slow macroeconomic recovery, the scope of unprecedented monetary policy here and in other major markets, fiscal-policy woes, too many parts of the world that remind us starkly of geopolitical risk combined with yield-chasing and market reconfiguration make it clear that time isn’t on the regulators’ side.

But, my time this afternoon does not permit an in-depth discussion of each source of looming systemic risk nor – even more important – an assessment of their probability. All I can do in our short time together is engage you in a discussion of where I think systemic risk may come next to show that all of the post-crisis discussions of what might need to be done to prevent another near-death experience must draw quickly to a close. Without hard rules reflecting the very tough lessons we’ve learned, we will do it all over again, but possibly with even worse results.

So, let me now turn to a speedy – if sobering – review of possible near-term sources of systemic risk:

- **Geopolitical Risk**: We’ve done too many rounds with this since the fall of the Berlin Wall to discount it, but recent developments in Ukraine and the Middle East are an urgent reminder of just how fast geopolitical risk can turn into a threat to macroeconomic growth and financial stability. Concentration risk and similar issues are as germane here as they are to the credit-risk concentrations on which regulators are focused, but policy to date hasn’t factored geopolitical risk either into contingency planning stress tests, or central-bank operations. Long past time to do so.

- **Monetary Policy I**: Awesomely accommodative monetary policy is dropping rates not just to the basement, but also below it in key markets each time geopolitical or other stresses show themselves. As has been widely discussed, low rates lead to yield chasing and yield chasing leads to asset bubbles that can burst with devastating impact. Debt issuers can also take advantage of low rates to put a lot of paper into financial markets they can’t roll over without a whole lot of interest-rate and foreign-exchange risk. If too much comes due too fast, a serious negative feedback loop could ensue. Asset-management companies could be particularly vulnerable to this if they are sitting on big books of low-rate paper that cannot quickly be normalized to new market conditions.

- **Monetary Policy II**: Central-bank actions are of course supposed to stabilize markets even as they must promote employment and press hard against inflation. However, unprecedented accommodative policies pose risks all their own. Maybe the FRB’s new reverse-repo facilities will solve for this; maybe not, especially given the reliance the program posits on money-market funds that are themselves significant sources of potential systemic risk. And, should fast-changing rates spur EU deposits back into MMFs, these funds might be more secure, but only at grave cost to the EU’s still all-too-fragile banking system. With every day bringing another estimate of the mammoth size of the reverse-repo program – with the FRB now saying the impact will be nor more than $300 billion – I worry also about the program's own complexity and the ability of the FRB, like any other financial institution, to manage it under stress.

- **Asset Shortages**: In part due to current monetary policy and the huge holdings central banks now have of high-quality assets (HQAs), Treasuries and similar gilts are in very short supply. Current and prospective rules exacerbate this because big banks will need to hold hundreds of billions more in HQAs to meet liquidity and margin rules. Of course, they will also have to hold large amounts of leverage capital against these in the U.S., creating an array of collateral-transformation and market-reconfiguration issues little understood at present. The one thing that global central bankers know is that the combination of all of these rules could lead to such acute HQA shortages that effective monetary policy is compromised. Add geopolitical risk into the HQA picture, and you also get scenarios in which "fails" in repo markets could reoccur with devastating impact. If we beat that reaper, then much of the overnight market may go from banks to hedge funds, creating another potential crisis due to the lack of comparable prudential rules in the "shadows."

- **CCPs**: Global regulators want derivatives trading out of dealer banks and on to central counterparties. However, as this occurs, trades will be increasingly concentrated in financial-market utilities for which rules are incomplete and resolution protocols non-existent. Under stress, CCP risk could be rapidly downstreamed to CCP members, creating a liquidity freeze and even endangering markets if members like big broker-dealers and asset managers lack ready resources to keep the CCP's lights on.

- **Rehypothecation**: An array of markets now engages in active asset rehypothecation. This promotes market efficiency, not to mention boosting profits. However, under stress, it's far from clear that broker-dealers, banks, and asset managers that engage in high-speed rehypothecation could find everything they owe to others and then put all the pieces back fast enough to prevent another panicky flight to the exit.

- **Cyber Risk**: In some ways a variation on operational risk, cyber risk has also now taken on geopolitical proportions. As such, it's even scarier. So far, everyone thinks they've got these risks under sort-of control. What scares me most, though, is not so much whether each SIFI can handle cyber threats, but whether inter-connections among them and through their vendors and connection points will prove sufficiently robust. The lights don't have to go out long for bad things to happen, especially in the payment, settlement, and clearing arenas.

- **Assume the taper doesn't take the EU out and there's still a lot to worry about. EU Financial Markets**: As another midnight scramble last month in Portugal made all too clear, there's a lot of dirty laundry in the EU banking system yet to be aired out, washed clean, and sorted into tidy piles. Geopolitical risk that further depresses macroeconomic growth in the EU adds an external stress to still strained bank soundness, especially in peripheral nations that, like Greece, can overnight challenge larger economies and their G-SIBs and G-SIFIs.

- **China**: The only nice thing I can say about the Chinese banking system is that most of it's sunk in a currency that can't be freely exchanged in global finance. However, China like Japan, sits on huge amounts of U.S. Treasury and similar obligations. What they do with them under which stress scenarios can very quickly play into the HQA, geopolitical-risk, and even cyber scenarios briefly outlined above. Even if China doesn't want to do any damage, it might not be able to help itself given the scope of its shadow-bank and corruption problems, each of which is compounded by slow growth and commodity shortages.

- **Asset Management**: I mentioned two asset-management issues – rehypothecation and CCP risk – but there are others specific to this sector. Yes, I know, asset managers mostly just manage other people's money, meaning that the risk lies with the investor, not the manager. However, an increasing array of asset-management activities put balance sheets or funding at risk. In the absence of effective prudential regulation – still scant in this sector – bad things could happen to big firms or funds, let alone the little ones that showed systemic potential in 2008.

- **Insurance**: This is a hotter priority for global regulators than asset management because of the big role insurance companies now play in securities financing. The more bank regulators turn the screws on this business line, the greater the risk to insurance companies, they fear. And, if the taper or something else roils repos, insurance companies may be particularly vulnerable to stress for which insurance rules ill prepare them. Regulators also fear that reliance on insurance companies as maturity or liquidity transformers could quickly turn systemic. Some of this, I think, comes from the legacy of the crisis, where municipal-bond insurance companies posed systemic risk. That sector is a shadow now of itself, but other non-traditional insurance activities – especially in the U.S. through REITs and reinsurers – still spook global regulators.

- **GSEs**: Remember them? Theoretically, their conservatorship has solved for systemic risk, but theory is far from practice. Fannie Mae and Freddie Mac still sit on trillions in obligations on which the global financial market depends without a scrap of their own capital to back their bets. Regulation under their conservatorships makes them better, but far from bullet-proof, as recent, scary stress tests show all too clearly. The hundreds of billions in an increasingly shaky Home Loan Bank System also warrant systemic notice.

As this list makes clear, not all systemic risk derives from what I've called the evil-banker theorem. That is, despite the risks that bankers took for which they were too amply rewarded that cost millions of people their homes and livelihoods, bad things can also happen to financial markets with little, if any fault of even the very biggest bankers. Why is this?

A review not just of my list, but also of recent systemic-risk experiences tells the tale. Of course, one can posit the evil-banker – and I'll add the lax-regulator theorem – to the late-1980s Japanese collapse, the 2008 U.S. cataclysm, and the one that followed all too fast in the 2011 EU repeat. But, remember also events like 9/11 that took out the World Trade Center towers and, below them, the hub of global payments. Was this the banks' fault or the Fed's? Maybe in that they didn't plan ahead for catastrophic risk, but then who does? Same for Hurricane Sandy just a year or so ago – the New York stock market made it through the storm, but just barely along with the rest of us.

We can try to regulate banks so that nothing can harm them, but if banks can't get out of bed in the morning, we won't have banks. If we don't have banks, I'm not sure how much financial intermediation we'll have until non-banks figure out this new game – as they already are.

In this talk, I won't focus on resolution. I sent a comment letter to the FDIC earlier this year http://bit.ly/1f7RbNm raising my concerns about the single-point-of-entry resolution protocol and suggesting some near-term actions to address them. That was then, this is now and nothing more has surfaced from the FRB and FDIC beyond flat-out rejection of eleven big-bank resolution plans that fuel belief that TBTF is still a big to-do. If there is a collision between an incomplete resolution framework and new threats to financial stability – regardless of from where they come or which financial institutions are destroyed – TBTF believers may well be proved correct.

The key to handling systemic risk isn't trying to predict every source of it and, then, bullet-proofing banks against it. They can't live in fall-out shelters any more than the rest of us. The cure is instead to establish protocols that do two things: enable governments to intervene when events spiral out of control for reasons that have nothing to do with ordinary prudential considerations and ensure that, even under acute stress, the biggest banks – as well as their financial-industry competitors – can fail if fail they must without taking the rest of us down with them.