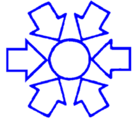
Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: August 28, 2020

The lower for longer premise on which the Fed's new policy depends may or may not bring the recovery for which we all hope so devoutly, but lower-for-longer rates in the real world for sure mean higher-than-ever systemic risks. One of the most important of these is the economic inequality certain to get dramatically worse due to the combined impact of COVID and ultra-low rates. Given that inequality is a demonstrable and perhaps even driving cause of financial crises, this is more than disconcerting. However, even if one discounts the inequality/crisis nexus, plenty of more accepted accelerants of systemic risk will flare still higher thanks to lower for longer. This is not just due to the asset bubbles rightly cited in today's *Wall Street Journal* editorial. Another proven, if less recognized, systemic-risk builder is the fact that lower-for-longer rates also turns regulated banking and insurance companies into losers for longer. Financial companies that cannot make money providing macroeconomic-essential services are financial companies that either get out of mission-critical businesses or fail. Either way, the Fed will rue what it wrought.

Although second-quarter earnings for some large banks were bust-out numbers, these came from trading and capital-markets services, not banking. Banking at its basics is financial intermediation – the business of taking deposits and making loans. In theory, low rates for deposits should ensure low rates for loans with a nice net-interest-margin (NIM). In practice, those days are way long gone because many nonbanks make the loans on which rates are higher even during periods – as now – when risk premia are scandalously low. Banks cannot compete in these higher-risk asset classes not because they're just too nice-minded to do so; it's capital costs that make them uncompetitive.

The Revlon loan on which Citi is now facing such embarrassment, not to mention as much as a $900 million hit, is a classic case. Once, prudent banks wouldn't have considered making this loan, especially given the "cov-lite" basis now a daily fact of life in high-risk markets. If banks refused to make the loan because risk-adjusted spreads were too slim, then the company wouldn't have gotten the loan and, a zombie firm would finally encounter its long-overdue demise. Thus, either a bank would have made money and a fundamentally sound company would come back to life, or there would be no low-cost, high-risk loan.

Now, we have the worst of all worlds – banks desperate for fee income taking acute operational risk, nonbank lenders yield-chasing to make their own NIMs make some kind of sense, and zombie companies marauding, sapping the economy of the life blood needed to fund sound ventures.

Lower-for-longer rates thus turn big banks into agents for nonbank risk-takers, fueling systemic risk outside the regulatory perimeter and starving the economy of essential, equitable-growth

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enhancing intermediation. And, if banks can't transform themselves into agents, traders, wealth managers, or infrastructure providers in lieu of remaining intermediaries, then the sheer force of competition from nonbanks, bigtech, and foreign firms will force U.S. bank earnings into a swoon from which they may not recover. Few but their shareholders might mourn them were it not for the fact that, as former Treasury Secretary Summers has pointed out, banks without robust market capitalization are banks that can collapse with devastating systemic impact.

Even worse, banks aren't alone in the lower-for-longer crucible. Insurance companies, especially life providers, have been in the lower-for-longer vise at even greater strategic cost than most banks because the essence of long-term insurance is longevity-risk management. Assets bought now must yield enough in forty years to ensure claims-paying capacity and, when assets yield less than likely pay-out required for longer and longer terms, insurance companies experience one of two fates: they take higher and higher risks to earn sufficient returns or they get weaker and weaker. These days, insurance companies are managing to get both riskier now and weaker later at the same time because one critical asset class in which they are heavily exposed – commercial real estate – is under stress due not just to the market bubble over the past five years, but to COVID's devastating impact on office buildings, retail space, and multi-family housing. The Fed knows this – indeed, it said this in its last financial-stability report. Even so, all it's done now is make matters worse.

To be fair, the Fed did think a bit about financial stability as it enshrined lower-for-longer, yesterday releasing a staff paper assessing the implications of prolonged low rates for systemic risk. We will shortly provide clients with an in-depth analysis of this paper. In short, it concludes that, while good monetary-policy controls are essential for financial stability – fine so far – "plausible scenarios" might arise in which low rates mean high risk – grudging recognition, but at least some. However, the Fed staff paper goes on to argue that good central-bank communications quell systemic risk – really? – and that an even better tool for this purpose is macroprudential regulation. This might make sense if the Fed had macroprudential power, but it doesn't.

Ergo, the Fed is betting it can somehow control markets and succor regulated intermediaries even as it upends their basic business model for the foreseeable future in the midst of grievous macroeconomic risk. It had better be right.