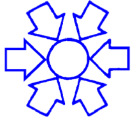
Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: April 25, 2022

Although Ukraine and emerging-market distress were the most frequently discussed topics around last week's Bank/Fund meetings, two other high-impact issues were also top of mind. One is the end of the international financial order as we've known it for decades; I'll return to this shortly as well as in my forthcoming book. The other to which I now turn is more immediate: commodity-market stress and what regulators will do to avert it if they can. I have heard a lot about a number of options, but I fear that regulators will do what they always do when trouble lurks: double-down on banks under their thumb instead of flexing their muscles to govern nonbanks at the heart of the global financial infrastructure.

In the commodity markets, as in all but the most direct financial-intermediation functions, banks are increasingly risk enablers, not takers. This isn’t because banks are just too darn good; it's because they are regulated and, after 2010, regulated to the point at which the capital costs of engaging directly in key businesses outweighed the profit potential in financial markets where nonbanks do not face the same costly constraints.

Going back to 2011, we've pointed out that asymmetric market regulation leads to rapid risk migration. In market after market, nonbanks have driven prices down to the point where they can still earn comfortable margins, pushing banks saddled by capital, conduct, and risk-management standards to bow out of a market except where legacy assets such as low-cost funding and vast networks have remaining competitive value. One such source of bank fee-income opportunity was the repo market, which showed the strength of rules in terms of bank resilience and the profound risks of rules-free financial institutions in the systemic crisis of 2019. The Fed fixed this one with yet another bail-out, although that only lasted until March of 2020, when still more billions were needed to secure still other corners of fragile Treasury markets.

Now come commodity markets. To the extent these are holding their own, it's partly because markets expect another bailout and partly because prime brokers housed at the biggest banks are providing a lot of liquidity, much as they did in the run-up to the repo crisis. This will work for as long as it works and, if stress grows to untenable levels, it will still work for banks because – again as in the repo crisis – banks will more than likely get out when the getting's good. This is fine for banks but deadly for systemic stability because critical financial markets have only fragile liquidity and solvency bulwarks with which to withstand markets denuded of bank liquidity backstops.

It was clear from day one of the post-2008 financial crisis that establishing centralized clearing houses would better facilitate market resilience than OTC markets if and only if these central points were stable points. Unfortunately, as it turned out, markets were generally forced to abandon OTC trading by all the rules imposed on banks, but the central points to which trading migrated remain largely rule-free. CCPs and similar systemic financial infrastructure are still privately held entities

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that, especially when these are not governed as systemic financial market utilities, are also outside the reach of safety-and-soundness and resolution standards.

As the global regulators realized after the 2020 crisis, central counterparties also act to save themselves and, because they need to act with even greater urgency than banks, they quickly ramp up margin requirements, accelerating systemic liquidity shocks. This week, Global regulators and the IMF observed this with specific regard to commodities markets in the turmoil following Russia's invasion. Still, what's the solution?

Regulators and the Fund clearly wish it were better regulation of the commodities market. However, doubtless knowing themselves all too well, they appear to have abandoned any realistic hope of vital, substantive, structural change. Instead, it's back to the banks, with the regulators and the Fund again targeting prime brokers and outlining new rules they think might just do the systemic trick.

If big-bank prime brokers get tough new standards, big-bank prime brokers will either figure out a work-around that moves risks without necessarily reducing it or just abandon yet one more lucrative activity. Regulators might get what they want – safer banks – but they'll also get what they've unwittingly constructed time after time since 2008: financial marketplaces that are essential to stable macroeconomic growth perched on skinny pins of central clearing counterparties. Bank regulators will look even tougher, but financial markets will prove still more fragile.