



MEMORANDUM

TO: Federal Financial Analytics Clients
FROM: Karen Petrou
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Later today, the FSOC will open its sanctum for what promises to be a brief session of largely political theatrics. One can only hope that the rarefied air of the Council's closed-door meeting elevates actual action addressing growing signs of financial instability. Sadly, FSOC's record of timely intervention ahead of any systemic event since its creation – and I count at least four – is dismal as are the Fed's see-no-evil financial stability reports. As of this writing, the U.S. is on the precipice of another “dash for cash” and no one – not the bond market, mutual funds, MMFs, investors – has any sandbags at the ready beyond faith that the Fed will bail them all out all over again. Loose lips sink financial systems, but lips that are zipped only because they have nothing useful to say do the same and then some.

As each FSOC annual and Fed financial-stability report makes clear, these guardians of stability quickly spotted “shadow-banking” risks that deeply worried them after the 2008 debacle. Still neither did much about them beyond pointing fingers even as flares streaked across the market warning of looming systemic shocks. As we predicted as [early as 2011](#), asymmetric systemic regulation accelerates systemic-risk migration from regulated institutions with established contingency plans and central-bank backstops to entities largely or even entirely outside the regulatory perimeter on which financial stability has come almost entirely to depend. This is a classic “money-for-nothing” set-up in which entities operate at increased profitability thanks to regulatory exceptions that are then made whole by the central bank on which they implicitly relied for rescue.

Would 2020 have happened if 2008's hard lessons had been better learned? The crises are different because one was purely financial and the second began as macroeconomic before this spark set the financial system ablaze. But, in 2008, there was significant contagion risk from banks to nonbanks; in 2020, risks ran in reverse as nonbanks infected the financial system, threatening banks and even the ability of the U.S. Treasury to conduct crisis-essential fiscal policy interventions.

Just as post-2008 hand-wringing led largely to a lot of in-depth reports about nonbank risk, the even more frightening 2020 financial crisis led only to a raft of reports along with a proposal or two from the SEC. These provide exhausted histories of each step in the dash for cash as well as recommendations for action in areas such as mutual-fund and MMF resilience, Treasury-market restructuring, and margining resilience. But real change is hard to find either in edict or self-regulation in the wake of lessons learned. Even as U.K. pension funds were coming up so short on margin calls that the Bank of England needed to bail out its gilts, global regulators issued a [massive report](#) on margining that called for little more than better CCP behavior and still more study of the OTC arena.

Markets now have no time to read. They're on a knife's edge, fearing that galloping gilts will spook a Treasury stampede. The gilt rout was bad enough in the U.K.; a similar dash for cash in

Treasuries has systemic implications that could reverberate around the world at a time of acute inflation, macroeconomic fragility, and geopolitical danger.

And that's not the only thing that could go wrong. Late last week, Bank of America [analysts said](#) the credit market was close to collapse and equity markets are clearly in extremis. This is the "everything bubble" deflating and, if the air comes out slowly, then stability will return after a new generation of investors learns the hard way that markets can go down at pain even the most profligate central bank can't prevent.

Financial crises are an inevitable side of financial markets. However, we have had them to greater or lesser degrees in 2008, 2011, 2012, 2014, 2019, 2020, and maybe 2022. The enormous U.S. and global apparatus established after 2008 was supposed to forestall at least some of these as well as anticipate the rest and then mitigate them via safety nets at cost to speculators, not taxpayers. I'm all for deliberate thinking and due process, but two years is a long time to wait for something meaningful that assures financial stability under well-understood stress without still more central bank bail-outs that stoke still more moral hazard.