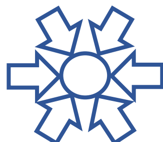

Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: February 21, 2023

Although the always-inscrutable FSOC's read-out of its last meeting was clear only with respect to approval of prior meeting minutes, the brief mention of ongoing U.S. work to address nonbank financial intermediation (NBFI) was so tantalizing that we ventured down darkened corners of key agencies to get a read-out of our own. Two conclusions came to light: the U.S. will take tough action on limiting bank/NBFI interconnections in its pending bank capital rewrite and FSOC is fine with the SEC's recent MMF and open-end fund proposals even if pretty much no one else is.

First to the capital rewrites and how costly they could be. In its most recent NBFI review, the FSB took sharp issue with the extent to which the U.S. has taken sufficient steps to curb the inter-connected risks to NBFIs evident even before the 2020 market collapse. We expect the banking agencies not only to issue the end-game rules discussed in my last memo, but also to make good on the U.S. promise to Basel well before the game nominally ended with the 2017 revisions.

This means new capital standards costing banks big when it comes to bank equity investments in funds and higher risk weightings for exposures to unregulated financial institutions. It also means new capital requirements absorbing "step-in" risk – i.e., the extent to which reputational risk forces banks to stand by their off-balance sheet funds, SIVs, or other instrumentalities. Two banks in fact supported affiliated funds in MMFs during the 2020 crisis, adding urgency to this concern and countering prior arguments that only investors – not sponsors – bear fund risk.

Beyond these capital rules, FSOC is revisiting its 2015 ideas to reduce inter-connections between big banks and investment advisers. Much in FSOC's outline for investment funds is now being visited upon hedge funds, family offices, MMFs and OEFs (see below), but FSOC saw a lot of other systemic risks it wants to quash.

What's still left undone are proposals to curtail concentrated or affiliated market infrastructure supporting NBFIs, restrictions that would impose firewalls and other constraints on big banks with significant asset-management operations as well as on the few banks with major custody or transfer-agency operations. Almost a decade ago, FSOC doubted the extent to which post Dodd-Frank GSIB and financial-market utility designations fully ensured resilience under stress and objectivity in the face of conflicts of interest. Maybe now, these standards and the broader GSIB construct suffice. Then again, maybe not.

There's a lot on FSOC's plate and we expect them to do little in public beyond prod the banking agencies to do FSB's bidding on overdue capital standards, turning back to systemic questions only after FSOC has finalized the pending, sure-to-be-controversial rewrite of systemic-designation standards. But, while FSOC ponders, the SEC will continue to act, not only finalizing its investment-adviser and fund rules, but also moving fast on its controversial custody rewrite. As an in-depth FedFin report will detail, this does a lot to crypto and, largely unnoticed, also to banks acting as custodians. If the Commission persists and ends the fiduciary safety blanket and mandates custodial indemnification, the capital cost of acting as a custodian will go way up and the NBFI business model will change still more.