



MEMORANDUM

TO: Federal Financial Analytics Clients
FROM: Karen Petrou
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After SVB failed, Jay Powell told his monthly press conference that he found this “[baffling](#)” even though the Fed was the lead bank supervisor and the only one charged with its BHC’s oversight. At [Wednesday’s presser](#), Mr. Powell took a different, but still-indefensible tack avoiding responsibility for a looming threat by stoutly denying his ability to do anything about nonbank financial-stability risk. However, the Board has an express mandate under the [Dodd-Frank Act](#) to address it. To be sure, the Fed does not have direct regulatory authority over nonbanks as it now remembers it did over SVB. But to say that the Fed’s only power is over banks as he Wednesday did is at best befuddled. A baffled, befuddled central bank is a national – indeed global – hazard.

Of course, perhaps Mr. Powell isn’t befuddled and instead wants to ensure that a crisis he claims the Fed can’t avert isn’t one that damages its already-scant credibility. This wouldn’t be the first time the Fed defended itself at the expense of sound policy, but that makes it no less inexcusable. I’ll have more to say about this in a talk on the 28th, but last week’s [memo](#) looks at just one threat to financial stability and what the Fed could readily do to combat it.

The threat comes from the \$1.4 trillion private-credit market’s ambition to use its regulatory-arbitrage advantage to morph into a \$40 trillion fixed-income sector. Mr. Powell says all he can do is watch. But, is the Fed even looking? It issues a semiannual financial-stability report that has missed every crisis since its inception and says nothing about private credit in its last release.

And the Fed can do a lot more than improve its analytical acumen. One reason it misses so much is that all it carefully looks at is banks. Until surprised by SVB and other recent bank failures, the Fed comfortingly concluded that all its new rules and presumed surveillance ensure that banks are not just safe and sound, but also stalwarts of systemic resilience. This is a very hearty pat on its own back, but one that proved incorrect in March while still more evidence that Fed financial policy has crafted wholly asymmetric standards. The more the Fed allows federal financial regulation to center only on banks, the more nonbanks supplant banks, the less resilient the financial system, the greater the odds of still more Fed backstop facilities and liquidity windows, the higher the moral hazard, and the less banks matter to anyone but the communities and customers who miss them.

Further, the Fed is not just a hapless maiden atop a tower as battle rages on the field below. It sits on the Financial Stability Oversight Council expressly charged not just with spotting systemic risk, but also doing something about it. Sure, the Fed doesn’t chair or control FSOC, but it’s not exactly the member representing state insurance commissions when it comes to FSOC clout. The Fed has enormous clout over FSOC, especially at a time such as now when the Treasury Secretary is in complete alignment with the central bank.

On its own or following FSOC’s lead, the Fed can and should throttle inter-connections to nonbanks that pose systemic risk. For at least a little while longer, each of these sectors relies on banks for an array of critical services. Curtailing these would circumscribe nonbank ability to grow increasingly interconnected at macroeconomic- and systemic stability risk. Banks will surely complain about the cost of lost business, but any of them with foresight will know that this short-term pain is essential to avoid a long-term transformation of even the biggest banks into little more than distribution stations for more powerful and profitable competitors.

The Fed can and should also step back from its de facto role as market-maker of last resort and, via the overnight reverse-repo program, also the borrower of first resort for MMFs. The fundamental edict of central banking is that central banks should provide emergency liquidity only to solvent banks and then only at penalty rates in exchange for good collateral. That the Fed no longer even comes close to this for banks or pretty much anyone else is no excuse for being

even more profligate for nonbanks with little to any role as financial intermediaries.

And then there's the Fed's direct impact on financial stability by way of its huge portfolio and the impact this has on supply and demand in systemic-critical fixed-income markets. Mr. Powell's Wednesday comment detailed the committees on which Fed staff think about fixed-income risk, but went on to say that the central banks needs the overnight reverse repo program to make monetary-policy at least a bit more credible, thus saving itself at cost to long-term bank resilience and near-term Treasury-market volatility.

And of course none of this is even counting how a decade-plus of ultra-low rates accelerated U.S. financialization, economic inequality, and financial instability. The Fed resolutely abjures responsibility here, [saying](#) as recently as Friday that monetary policy and financial-stability protection are on wholly separate paths, with monetary-policy objectives trumping those germane to financial stability because that's how the Fed reads its mission.

This is yet another instance in which the Fed intentionally reads its mandate under the Federal Reserve Act as narrowly as possible, ignoring the overarching instruction in the U.S. Code that it also promote the "general welfare." We can't have truly general welfare if Fed policy undermines capital formation and ground-up economic development, each of which has been gravely damaged by the Fed's focus first on financial markets and then on itself. The Fed clings to the ideal of "independence, but this cherished defense against political accountability only makes sense if the central bank keeps its eye on the polity and remembers it is sworn to protect it.