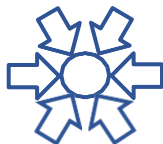

Federal Financial Analytics, Inc.

# MEMORANDUM

**TO:** Federal Financial Analytics Clients

**FROM:** Karen Petrou

**DATE:** July 3, 2023

As was evident throughout Chairman Powell's most recent appearances before HFSC and Senate Banking, conflict between capital and credit availability characterizes what is to come of the "end-game" capital rules set for imminent release. The trade-off is said to be between safer banks and a sound economy, but this is far too simple. As we've seen over and over again as capital rules rise, credit availability stays the same or even increases. What changes is who makes the loans and what happens to borrowers and the broader macro framework, which in the past has been irrevocably altered. The real trade-off is thus between lending from banks and the stable financial intermediation this generally ensures and lending from nonbanks and the risks this raises not just to financial stability, but also to economic equality.

As post-2008 history makes clear, banks do not stop lending when capital requirements go up; they stop taking certain balance-sheet risks based on how the sum total of often-conflicting risk-based, leverage, and stress-test rules drives their numbers. That all these rules push and pull banks in often-different directions is at long last known to the Fed based on Vice Chair Barr's call for a "holistic review". Whether it plans to do anything about them and their adverse impact on the future of regulated financial intermediation remains to be seen. Until something is done, banks will look across the spectrum of capital rules, spot the highest requirement, and then figure out how best to remain profitable no matter what.

Strategies vary. Sometimes as in mortgages and corporate credit, banks originate a loan and then sell it into the secondary market. Sometimes if they're smaller banks, they originate a loan and then "partner" with a fintech to get the exposure off the balance sheet. When a corporate loan is suitable for the syndicated markets, banks also originate and offload. Credit goes forth, but risk moves out of the banking system to whomever is willing to take as much of it as the bank can profitably peddle.

Of course, sometimes there isn't a secondary market or a willing fintech. Then, banks will make the loans they can based on the risk they absorb versus the capital costs applicable to the exposure along with the fees obtained by extending it. If you want to know why many small banks are so big in CRE, it's because this market is still largely local, banks think they understand its risk, and the capital costs are acceptable in light of borrower willingness and ability to repay. Banks may well make too many CRE loans to concentrated borrowers in their markets, but the combination of capital rules and strong nonbank competition in other sectors makes CRE often the only credit offering regional banks can issue and then hold.

Credit availability also adapts to new capital rules because, where banks can't or won't make loans, new lenders often step in. This is true even in certain secondary markets – see the enormous growth of nonbank mortgage originators since 2010 and higher-risk corporate credit. Nonbank mortgage companies now have de facto federal regulation, but the vast sweep of "shadow banks" are otherwise allowed to do as they please.

My last memo detailed the meteoric rise and boundless ambitions of private-credit providers – i.e., all the hedge funds and private-equity firms now going where no banks dare or can afford to tread. More evidence is to be found in *Bloomberg* on Friday documenting the "flood" of loans flowing from regional banks to hedge funds and private-credit companies.

Which brings one back to the risk problem. Credit there is in most markets even if banks bow out due to capital costs. How sound or stable the credit provider is a different question.

As the BIS has pointed out, nonbank corporate lenders are considerably more procyclical than banks – that is, they aren't the through-the-cycle lenders essential for macroeconomic stability. Nonbanks also do not back their bets with the capital and liquidity deemed essential that is also way-expensive for banks. Nonbanks supplanted banks across the credit market after 2010 when the cost of capital and other rules became insuperable. When the system was crash-tested in 2020, it absorbed a tremendous shock, but only because of all the corporate debt, MMF, and other facilities the central bank crafted atop the tiniest of statutory reeds. What happens the next time? More bailouts?

Banks of course have had their own bailouts, but they pay for the privilege with all the capital, liquidity, FDIC premiums, and risk-management standards. That some rules may well need a rewrite is one thing; that they exist and force banks out of tried-and-true, economy-critical lending is also incontrovertible.

Where's the economic-inequality rub from regulatory capital? First, financial crises do the greatest damage to those least able to bear them. Further, retail borrowers may well continue to get loans after banks disappear due to capital costs, but new lenders are likely to charge a good deal more than banks not because of regulatory requirements, but due to uncompetitive markets and exemptions from an array of risk-management and community-development obligations.

Think for example of auto loans, increasingly provided by nonbanks that are often dealers with significant conflicts of interest that may well ensure a lower-income borrower gets a loan, but the borrower may also pay directly or indirectly a lot more for the car. When banks got out of the personal installment-loan business in large part due to capital costs, payday lenders stepped right in. Credit there is; costs direct and indirect to borrowers and communities are the key difference.

If banks lost business to nonbanks because banks are no good at persuading customers to use their services, so be it. But banks are outflanked by nonbanks largely because the market is rigged by force of rule. FDIC Chairman Gruenberg recently said that his prime concern is making banks as safe as possible and, if the shadows lengthen, over to FSOC and the FSB for something, sometime.

This is a short-sighted view of a financial system at ever greater risk by virtue of the changing nature of banking in response to new rules and the migration of many other risks outside Mr. Gruenberg's grasp. Unintended consequences really do count.