Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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What is capital? We talk a lot about how much banks should hold and what more bank capital means to whom. But few have said much about what regulatory capital actually is. That's a signal, strategic omission as private-equity firms spin a tale of capital resilience without actually having anything comparable to what banks must raise even as nonbanks take over more and more financial markets key to stability, economic equality, and macroeconomic growth. Let nonbanks compete wherever they can, but suggestions that private equity hold more capital than banks is a whopper that cannot go unchallenged as lending migrates to these powerful firms.

In a *New York Times* article over the weekend, Apollo's chief executive reiterated a point he's made before: that his firm's lending activities are backed by "more Tier 1 capital" than banks are required to hold. As the *Times* article then observes, the assets that "constitute" Apollo's capital and that of other PE firms are low-risk and thus a source of "permanent capital." Or so it is said.

But the assets Apollo calls capital are just assets – not capital of any tier – under banking rules. Assets they also are when one remembers how balance-sheets work. The billion-dollar balance-sheet question is always what stands between assets and liabilities if asset valuations drop. For banks and, indeed, anyone else with a balance sheet, that's capital – not more assets deepening the void between assets and liabilities.

The term "permanent capital" actually derives from insurance regulation. It may well be that Apollo holds more of the primary capital insurance regulators demand compared to some dollar amount of bank Tier 1 capital, but this is an apples to Martians comparison.

The business on which insurance regulatory-capital standards are premised is structurally worlds away from the business of banking. That's why insurance regulatory – still not balance-sheet – capital can be assets and bank capital must be shareholder equity or certain other very limited obligations – not assets.

In very short, life and property-and-casualty insurance is the business of managing longevity risk based on actuarial assumptions of how long policy-holders will live or when the next big storm rolls in. If insurers guess right – and insurance regulation is supposed to help them do so – then sufficient liquidity is tiered across the actuarial probabilities of claims-payment obligations and everyone ends up happy. The extent to which life insurers actually do this well is a longstanding financial-stability concern, but this is the model of insurance risks and requisite capital on which U.S. state insurance commissions and, to a lesser extent, global insurance regulators subscribe.

The first important question about the insurance-capital construct in which private creditors cocoon themselves is thus how well it actually applies to insurance in these modern times. Yes, insurance risk is principally longevity, but it also comes from interest-rate, operational, and market risks which fall under a different, albeit imperfect set of capital standards when it comes to banking and no capital at all for most insurers even when it comes to like-kind risks such as maturity mismatches, cyber-security, and equity-market downturns.

The apples-to-apples assertion Apollo advances is even more outer-worldly when it comes to credit risk. Credit risk is no longevity phenomenon; it can of course strike fast and hard. It is for this reason that bank credit-risk capital is based not on how much funding a bank has to cover losses, but on probability of default and loss given default. Leverage-capital ratios also demand capital even when there's little to no risk at all. These rules constitute a requirement that banks put up a lot of their shareholders' funds in the most important form of capital known as common equity Tier 1 (CET1). A major reform of the Basel III standards is tougher CET1 standards and the pending capital regs toughen that up even more. Banks do hold some assets to handle liquidity risk against funding-source turbulence, but these assets also bear capital requirements and are thus costly no matter how low-risk.

It's not hypothetical to say that insurance capital standards do a bad job absorbing credit risk. Private mortgage insurers learned this the very hard way in the great financial crisis because their insurance coverage was in fact a promise of payment upon borrower default – in short, it was and is credit enhancement, not insurance as commonly understood. Insurance regulators have since and rightly rewritten the MI framework, but they've yet to lay a glove on the trillion-plus in credit private-equity firms now hold on their books, let alone the $40 trillion or so to which Apollo thinks the business soon will grow. So no, private credit is nothing akin to bank capital and it's a risky business not just because of this gaping disparity, but also because private creditors generally hold higher-risk, more-concentrated loans.

There's much talk of like-kind rules for like-kind risk these days, but any assertion that private credit comes under this rubric is at best a stretch. There's no reason PEs can lend to companies if they want to lend to companies, but doing so with dollars given to them in annuity premiums distorts funding streams and puts policy-holders at risk. Saying that the assets into which these policy-holder funds are put is capital is still more fallacious because the point of these assets is to protect policy-holders via liquidation under stress, not to ensure lender resilience upon a borrower's default. Competition is more than good for markets; regulatory arbitrage is a clear and present threat to them and the broader public good.