Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Last Wednesday, Sens. Brown and Reed wrote to the banking agencies pressing them to cut the cords they believe unduly bind big banks to private-credit companies. The IMF and Bank of England have also pointed to systemic-risk worries in this sector, as have I. Still, FSOC is certainly silent and perhaps even sanguine. This is likely because FSOC is all too often nothing more than the "book-report club" Rohit Chopra described, but it's also because it plans to use its new systemic-risk standards to govern nonbanks outside the regulatory perimeter by way of cutting the banking-system connections pressed by the senators. Nice thought, but the combination of pending capital rules and the limits of FSOC's reach means it's likely to be just thought, not the action needed ahead of the private-credit sector's fast-rising systemic risk.

One might think that banks would do all they can to curtail private-credit competitors rather than enable them as the senators allege and much recent data substantiate. But big banks back private capital because big banks will do the business they can even when regulators block them from doing the business they want. Jamie Dimon for one isn't worried that JPMorgan will find itself out in the cold.

Of course, sometimes banks should be forced out of high-risk businesses. There is some business banks shouldn't do because it's far too risky for entities with direct and implicit taxpayer backstops. This is surely the case with some of the wildly-leveraged loans private-credit companies fund all too often because, even though they know the risk, they hand it over to the borrower's hapless investors. Banks can't undertake these sleights of hand unless it's via the syndicated-loan market and, even there, regulators are on to them.

But, private credit's arbitrage-based activities aren't limited to those too toxic for banks to touch. Private creditors can also offer borrowers lower rates than disintermediated banks because banks must charge more to compensate for their cost of capital. The only solution here is to lower bank capital requirements – sometimes warranted, sometimes not – or figure out how to strangle private credit's access to the banking system and hope that drives borrowers back to its bosom.

This is clearly the senators' goal and it's also a critical new aspect of FSOC's revised systemic-risk identification methodology. But there's very little that bank regulators can do to stop private credit's march. Even if the services banks provide are essential – and none appears to be – the agencies can reach only U.S. banks and foreign banks will surely fill a profitable void. Foreign-bank capital standards are also often more accommodating, making them even happier to supplant U.S. banks.

FSOC also can't touch private creditors directly because none has a safety-and-soundness federal regulator. This leaves FSOC with only lender-by-lender systemic designation. That's a long, hard

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slog with a most uncertain ending. And, even if FSOC prevails, much of the sector will still be beyond its clutches.

The obvious solution to this dilemma is to give regulators such as the SEC and CFTC bits of authority over private-credit companies' broader safety-and-soundness powers. These agencies may now tackle only capital formation, investor protection, and similar hazards. None has the ability to protect a nonbank financial company from itself or insulate counterparties and shareholders from high-risk activities accelerated by the absence of guardrails. But, that it's hard for Congress even to rein in stablecoins after billions of dollars of losses is ample evidence that Congress can't do much of anything when it comes to financial standards, let alone those essential for financial stability. Still, it's a thought that could be turned into meaningful action given that nothing much else will work.