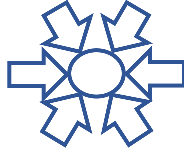

Federal Financial Analytics Brief*

January 4, 2024

Too Little, Too Late and Then Too Much, Too Fast: 2024 Forecasts and a Philosophical Reflection on Financial Regulation

> The iron law of liberalism states that any government initiative intended to reduce red tape or promote market forces will have the ultimate effect of increasing the number of regulations, the total amount of paperwork, and the total number of bureaucrats the government employs.**

In a brief we hope to keep as brief as possible, Federal Financial Analytics here details the most significant policy decisions determining the strategic outlook for banks and the broader U.S. financial system in 2024. This is sure to be a repeat of all too many other years in which enormous bodies of complex prior rules collapse under systemic exigency only to be replaced by still more rules built atop the quivering body of all the old rules combined with calls for new rules addressing new risks outside the banking system on which final action is partial, if any. This is a new form of boom-bust cycle spawned solely by public policy warranting careful attention. This forecast thus concludes with a short reflection by Karen Petrou on why pyramids of complex financial regulations and thousands of enforcement warriors are all too often doomed to fail.

To break the "iron law of liberalism" outlined above,[1] Petrou offers what might be called a libertarian solution that returns financial regulation to the construct long intended by U.S. law: regulators ready and able to close failing entities at cost to shareholders and senior management. This has seemed little more than an anachronism as the U.S. economy became increasingly financialized and the Fed turned its focus from acting only as a lender of last resort also to serving as a market-maker of first resort. The more the Fed bails out the market, the more the market expects all major players to remain as bullet-proof as they

---

* This brief is provided by Federal Financial Analytics (FedFin) as a contribution to a strategic understanding of likely outcomes of major financial-policy decisions pending in 2024. Drawing on referenced FedFin and third-party sources, it reflects solely FedFin's perspective and was not funded, sponsored, or otherwise affected by clients or public officials. Public-official views of which we are directly aware not otherwise noted in the public record may be referenced herein without citation or attribution.

** David Graeber, *The Utopia of Rules: On Technology, Stupidity, and the Secret Joys of Bureaucracy*, Melville House, 2015.

have in fact become and the more powerful the forces behind still more financialization instead of sustained funding for households, small businesses, and long-term non-financial productivity that does not depend on government subsidy.

2024 Banking-Policy Outlook

Pending Prudential/Resolution Standards

The big enchilada for 2024 U.S. bank regulation is of course the capital rules proposed in July of 2023 along with proposed long-term debt (LTD) standards for regional banks and, to a somewhat lesser extent, new FRB/FDIC resolution standards and a companion proposal from the FDIC only for insured depository institutions (IDIs). Each of these proposals is controversial and, in several cases, advanced without consensus on the Federal Reserve Board or that of the FDIC, making the two critical political developments affecting the final outcome:

- If FRB Chair Powell sticks to his vague promise that the final capital rules will proceed only with consensus, consensus that must surely involve considerable concessions from Vice Chair Barr; and
- whether Republicans are able to force out FDIC Chair Gruenberg, leaving Republican Vice Chair Hill holding the gavel and facing 2-2 splits on the FDIC board absent significant concessions perhaps beyond those needed to approve the rules at the Fed.

Our forecast assumes that:

- Mr. Powell does seek out consensus that forces concessions from Mr. Barr and Govs. Waller and Bowman; and
- Mr. Gruenberg hangs on or, should this not be the case, then the FRB and OCC proceed on their own with an interim final rule if the FDIC cannot approve anything acceptable to the FRB and OCC.

Based on our forecast for these wild cards and negotiations to date, we expect the following changes to the capital rules:

- a smaller scope of the capital, LTD, and resolution rules to banking organizations with assets over $250 billion and all their affiliated IDIs along with all intermediate holding companies (IHCs) established by foreign banking organizations (FBOs);
- minor changes to appease Congressional Democrats related to lower-income mortgages and tax-equity bonds;
- more favorable risk weightings for retail and small-business loans;
- application of the market-risk rules only to covered entities with material market risk;
- operational-risk capital revisions to align the U.S. proposal more closely to Basel's final standards;
- a slower LTD transition, with initial debt issuances set to prior capital ratios and those required under the new rules delayed until well after the capital rules become effective; and
- targeted capital standards (e.g., related to unrealized gains/losses) and less stringent resolution planning for banking organizations with over $50 billion and below $250 billion in assets.

Forthcoming Standards

Based on analytics to date, we anticipate the following additional standards:

- Bank Merger Policy: We expect long-awaited bank-merger policy now that the Department of Justice and Federal Trade Commission have outlined their antitrust methodology. This lays out the terms on which DOJ will review bank mergers and thus the extent to which the more lenient FRB consolidation policy will fare.
- Liquidity Regulation: Once the major prudential standards described above are finalized (2Q), the agencies will turn to revisions to the liquidity coverage ratio (LCR) and parallel shifts to the net stable funding ratio (NSFR). These will toughen the treatment of uninsured deposits and Federal Home Loan advances, enforce discount-window preparedness along with allowing recognition of likely draws, and mandate run-risk stress testing for intraday resilience at larger banking organizations. It is also possible that collateral pledged for FHLB advances or discount-window draws would need to be excluded from high-quality liquid assets at GSIBs or other very large banks to reflect lessons learned after the Credit Suisse failure.[2]
- Deposit-Insurance Reform: We expect no action because anything meaningful requires new law and Congress is unlikely to advance any.
- Cryptoassets: Once the major rules are finalized, the agencies will also propose new cryptoasset and stablecoin capital standards. We think there is a slim, but possible, chance of Congressional stablecoin legislation that will dictate broader regulatory parameters but not restrict the banking agencies with regard to capital or other prudential rules.

Systemic Standards

In its 2023 annual report, the Financial Stability Oversight Council (FSOC) reiterated many of its previous systemic worries about which nothing has been done even though some in the 2023 report harken back to the Council's annual iterations a decade ago. That would augur nothing new for nonbank interventions in 2024 but for the fact that FSOC now comes armed with a new systemic-risk methodology and designation process. This gives FSOC the tools it needs and November may give it the motivation to act on key priorities out of fear that the White House could change hands and the current agenda will be as gutted as that of the Obama Administration's FSOC after Donald Trump was inaugurated. What might be done to whom?

- **AI:** This is a new priority, but FSOC expressly plans only to watch and wait. Pending legislation may force FSOC's hand and it will take new law to do so.
- **Hedge Funds:** Highly-leveraged hedge funds are a top FSOC priority, but so it has also been for years. FSOC might direct the SEC to do something about hedge funds to the extent permitted under law, but the SEC has already proposed to do about as much as it can. So, again, it's watch and wait and, in this instance, no legislation is pending to force more direct action.
- **Nonbank Mortgage Companies:** FSOC here too worries a lot and here too a primary regulator, in this case the Federal Housing Finance Agency, has taken steps to limit nonbank mortgage company risk as far as it can with Fannie Mae and Freddie Mac. Over time, new data to be demanded later this year on bank call reports may give regulators the facts they need to limit bank backstops to this sector. This would have an immediate and dramatic impact, but it will take

months to know what the new data show and still longer for banking agencies to act even if they decide to do so.

- **Cryptoassets:** Here, FSOC is not in the stalled car's driver seat. Congress is hard at work negotiating a path to bipartisan crypto and/or stablecoin legislation. Agreement between both parties on each side of the Capitol appears more than elusive, but HFSC Chair McHenry (R-NC) plans to retire and Senate Banking Chairman Brown (D-OH) faces a tough reelection battle. Each may thus be more amenable to compromise for which a lame-duck Congress finds a spot on the legislative agenda.

Concluding Thoughts – Karen Petrou

It may well seem perverse to posit the iron law of liberalism's application to financial policy given the fundamental conservatism of most financial policymakers and financiers. However, a quick historical survey shows that the iron law has gripped U.S. policy ever since the New Deal. Ronald Reagan did famously say in 1986 that "the nine most terrifying words in the English language are: I'm from the Government, and I'm here to help,"[3] but the first post-Depression body of sweeping financial regulation was issued under his Administration and that of his equally-conservative successor, George H. W. Bush. This is the seventh U.S. financial crisis I have seen since I began my career in the midst of the S&L crisis that led to these standards, the first bout of financial regulation since the Hunt Commission pondered the need for rationalization in the 1970s.[4] Congress missed a great chance then to simplify banking rules; ever since, it's either enacted laws demanding thousands of new rules focused almost exclusively on banks or pressed regulators to add still more rules and additional staff under existing authority.

And so it went, with more rules, more "bureaucrats," and yet faster and faster waves of increasingly turbulent financial markets and resulting macroeconomic fragility. Some crises since the 1980s S&L debacle were averted by rescue without accompanying new rules,[5] but most came with both rules and still more moral hazard until the 2007-2009 great financial crisis.

This cataclysm precipitated massive bailouts followed by a new set of banking-industry rules whose complexity put that of prior decades to shame. At the same time, there were faint-hearted attempts to harness systemic nonbanks and ensure resolution without crisis, but little ultimately came of that. The subsequent 2019, 2020, and 2023 crises followed this playbook, with the Fed making ever more sweeping and imaginative use of its emergency-liquidity powers to support any corner of the financial system that gave it the willies.

The sum total impact of all this history is evident again in the new rules for banks and slow-go for nonbanks we here forecast for 2024. There will be many bank rules piled atop many bank rules, few if any addressing growing sources of proven systemic risk and continuing expectations of bailouts and backstops. This, combined with weak bank supervision and no nonbank safety-and-soundness standards, perpetuates a bank-centric regulatory model fulfilling the iron law of liberalism because there are still more bank rules and even more bureaucrats along with wider gaps in the financial system that force still more bailouts and backstops. Policymakers don't want to bailout and backstop, but they nonetheless bailout and backstop major financial companies because they rely on ever higher towers of bank regulation – not iron-clad resolution – as the system slips ever farther out of their grasp.

The way to break this iron law is to abandon hope that new bank rules and still more regulators and supervisors ensure renewed financial-system stability. Some rules are necessary, but what's far more essential is ensuring that companies that don't play by the rules die by their own hand. When companies falter due to no fault of their own, those with a statutory right to a federal backstop should get one, but everyone else should fail as Congress intends for entities exempt from costly standards or authorized taxpayer backstops.

Congress of course knows that blowing up big financial companies is a dangerous game. That's why it gave the agencies resolution power over banks, resolution power premised on unique federal benefits banks no longer enjoy. Congress also bolstered the regulators' hand in 2010, establishing the FDIC's orderly liquidation authority (OLA) to ensure that very big banks or nonbanks do not make a catastrophic bang if they blow up.

This was what the agencies said they wanted not just because Congress told them to ensure it, but also because none we know of wants to reward risk-taking. But it is clear that, to this day, neither the FDIC nor the Fed knows how to handle a failing bank or nonbank of size without bailouts or backstops.

As 2023 made clear all over again, they are unprepared to use the resolution tools they have designed to prevent these interventions. Knowing that they lack functional weapons capable of limited destruction, the agencies are also and not-unreasonably frightened that even mild systemic stress could have profound and damaging consequences. Unprepared and ill-equipped, they win kudos for preventing crises thanks to bailouts and backstops without policy or public opinion taking serious heed of whether the crisis could have been averted if the agencies had taken dangerous financial companies out of everyone else's misery.

Does it have to be this way? No, but change can only come if policymakers and industry recognize that the nation is doomed to piles of bank-centric rules that drive finance farther beyond their reach unless policy returns to a resolution, not regulatory, agenda.

Historically, banks fight hard to give the FDIC and FRB maximum latitude to allow troubled companies to struggle on, rescue faltering firms, minimize enforcement actions, and ensure the Fed steps in whenever trouble looms. This is sensible in the short-term, but the long-term price of evading costly resolutions and endorsing unlimited interventions is lots more rules that increasingly bury banks alive.

Ideally, essential, tough bank prudential and resolution standards would be matched by aligned nonbank prudential and resolution standards, but U.S. law does not permit this. As a result, banks fight hard to save themselves and avoid rules that put them at still more competitive disadvantage. In a rigged game, banks try hard at least to stay in the game, not take on the harder task of clearing away the card-sharks.

Regulators also fight hard to save themselves and that means blaming everyone else, not themselves. Given their limited jurisdiction, the only culprits against whom they can wreak vengeance that aren't themselves are banks. They could instead enhance their own resolution capabilities by ensuring internal capabilities and constructively addressing the FDIC Inspector-General's finding that the FDIC to this day doesn't know how to deploy OLA, but they don't. Instead, as noted, the pile of rules rises higher and the iron rule binds those subject to it, banks and policy-makers and all of us dependent on the financial system unless or until the radical change foretold in a series of recent books comes along and creates a new reality I fear none of us will much like.[7]

[1] Ibid, p. 1.
[2] Swiss National Bank. "Financial Stability Report 2023," *Swiss National Bank Financial Stability*, June 2023 https://www.snb.ch/en/publications/financial-stability-report/2023/stabrep_2023.
[3] President Ronald Reagan, “The President’s News Conference” (Chicago, IL, August 12, 1986). https://www.reaganlibrary.gov/archives/speech/presidents-news-conference-23#:~:text=I%20think%20you%20all%20know,I%27m%20here%20to%20help.
[4] Hunt, Reed O., *The Report of the President's Commission on Financial Structure & Regulation*, December 1971. https://www.nixonlibrary.gov/finding-aids/fg-267-presidents-commission-financial-structure-and-regulation-white-house-central.
[5] Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, Random House, 2000.
[7] Mitch Daniels. “Surrender. A Major Economic and Social Crisis Seems Inevitable.” *Washington Post,* (January 2, 2024) https://www.washingtonpost.com/opinions/2024/01/02/crisis-looms-united-states/.