Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Part one of my end-game assessment was last week's memo laying out the growing odds that the agencies will be forced to issue a new proposal which hopefully makes better sense than the current one. Part two here points out how the agencies have so tightly wrapped themselves around the capital rule's axle that they are unable to see how many even more critical challenges are going unaddressed. Risks overlooked are often risks even the toughest capital rules cannot contain because the cost of new capital rules actually contributes to the arbitrage and risk-migration accelerating the pace of systemic-risk transformation. This is a negative feedback loop if ever there were one.

The new capital rules will be outdated by the time they are finalized because financial institutions of all persuasions will take advantage of every bit of regulatory-arbitrage opportunity within and across borders. That the banking agencies and FSOC aren't even thinking about how this might happen makes it still more likely that they will. This is not to say that no changes to capital rules are warranted. Some changes are overdue, but capital rules crafted in a vacuum will not stand up to real-world circumstance.

The collective book reports issued by the Federal Reserve in its semi-annual systemic forecast and the FSOC's annual reports are remarkably backward-looking. Focused more on not saying anything too frightening and bolstering ongoing initiatives, these tomes have long been and sadly still are poor auguries of risks to come perhaps all too soon.

Even as the FRB and FSOC are unable to act, two recent *Financial Times* articles are important reminders of threats they neglect. The first points to the cause of the mid-March failures: not capital shortfalls, but liquidity chasms. We'll never know if the viral runs that toppled SVB and precipitated subsequent failures would have turned into solvency crises from which only capital could have saved them since these banks were ill-prepared for acute stress and discount-window draws and all too dependent on fickle Federal Home Loan Banks. Yet the agencies have prioritized capital reforms ahead of the liquidity rewrites they readily recognize combined with supervisory malfeasance to trigger what became a systemic rout.

Acting Comptroller Hsu two weeks ago signaled that the agencies are now planning to do something about this sometime soon. Sooner would be still better in an era of acute geopolitical risk, ever more viral social media, and regional banks now bereft of the beloved BTFP. Even if a liquidity-rule rewrite is released in the next month or so, the agencies will need to allow for at least a sixty-day comment period, putting finalization well towards the end of this year, if then. Implementation will take time, meaning that many banks will not change until change may come too late.

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The second *FT* article is still more frightening because its focus – new forms of embedded financial-system leverage – isn't even on the regulatory radar. One case in point is that debt is now frequently extended by nonbanks, making the level of a borrower's leverage opaque to all of its lenders and to regulatory efforts to spot macroprudential trouble spots. As is all too often the case, history repeats.

This time, the lesson comes from the 1980s less-developed country debt crisis, which blew up in the banking system's lap because no one knew how much debt sovereign nations had actually taken on. The Institute of International Finance was originally created precisely to aggregate data on these sovereign debt loans across the banking system to prevent this type of leverage and so it did for as long as banks were the key source of emerging-market debt.

Who's gathering data now on the total outstanding obligations of NBFIs and corporate borrowers? The banking agencies are now asking for comment on gathering these data from banks, and it's about time, but much of this leverage is outside the banking system and thus unknowable until it's uncontainable.

And, then there's illiquid "liquid" collateral and the surprise leverage one discovers when a "secured" commitment isn't. We saw how Credit Suisse couldn't monetize its assets because they were multi-pledged and the same was true on a smaller scale for Signature Bank. The more bank rules capture the encumbrances of what are supposed to be highly-liquid assets – and pending rules will surely do so – the more of these assets banks will have to have, the safer banks will be, the fewer unencumbered liquid assets there will be for others, and the greater the risks associated with the high-stakes, high-reward game of collateral transformation.

And there are of course many other risks, some noted in ponderous Fed and FSOC prose, others not yet on their collective radar. As I noted last week, stablecoins are about to top $1 trillion following the sector's migration outside the SEC's clutches. How long will the agencies duck behind Congress' skirts while they await unlikely federal statutory clarity before they limit market interconnections hinted at during the Silvergate and Signature failures and lurking across the financial system?

Are regulators sure that the financial system will stand secure in another bout of geopolitical risk or will CCP and OTC margins pose another bout of acute stress leading to still more calls for yet another Fed window? Global regulators fear this, but no one seems ready to avert them in the face of ongoing market-liquidity stress. All sorts of operational risks lurk for which capital is not only no cure, but often also counter-productive.

And so it goes, new rules to bandage old regulatory-agency battle wounds as finance moves to new battlefields.