Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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As the pending U.S. capital rules head into their own end-game, there is finally a good deal of talk about an issue long neglected in both public discourse and banking-agency thinking: the extent to which higher bank capital rules accelerate credit-market migration. Simple assertions that more capital means less credit are, as I've noted before, simplistic. One must consider how banks reallocate credit exposures to optimize capital impact and, still more importantly, how the credit obligations banks decide to leave behind take a hike. Now comes a new paper the *Financial Times* touts concluding that, thanks to shadow banks, "we can jack up capital requirements more." Maybe, but not judging by this study's design. Even with considerable charity, it can be given no better than the "very creative" grade which kind primary-school teachers accord nice tries.

The paper in question is by Bank of International Settlements staff. It looks empirically – or so it says – at what it calls the U.S. banking sector's share since the 1960s of what it lugubriously calls "informationally-sensitive loans." It documents a lot of numbers said to demonstrate lower bank lending share, using a model founded on both erroneous data and wild leaps to conclude in a fit of circular reasoning that more nonbank lending explains why there is less bank lending. In the study's words, "intermediaries themselves have adjusted their business models." What might have led banks to decades of technological intransigence and strategic indolence is neither clearly explained nor verified.

What else is wrong? For starters, the paper's definition of banks – more than a bit fundamental to conclusions about banks – is at best perplexing. U.S. banks are defined to include credit unions – which of course operate under wildly-different capital rules – and foreign-bank "offices" even though branches and agencies – maybe in the data, maybe out – operate under home-country rules, not those studied here.

One rationale described in the paper for the decline in "bank" balance-sheet lending is the development of securitization markets. True were it not for the fact that the paper goes on to assume that banks that securitize "informationally-sensitive" loans are equivalent to shadow banks. As a result, all bank-originated loans that are securitized are considered to have been originated by shadow banks even though they weren't. This may make the model work in terms of demonstrating that banks can handle more capital without cost, but it's structurally ludicrous given the trillions of retail and wholesale obligations banks churn into asset-backed securities every day, a decision they make in good part based on regulatory capital and liquidity incentives conveniently omitted from conclusions about regulatory impact because any bank that sells a loan ceases to be a bank for purposes of the paper's data and model-based conclusions.

Even more structurally dubious, the paper assumes that it is "savers" who determine the size of bank balance sheets. Thus, if savers decide to go elsewhere, banks must shrink. "Savings" are

so expansively defined as to obscure the actual liabilities that support intermediation. Alternatives to traditional deposits for “savers” are said to include not just MMFs and mutual funds, but also pension funds – only sort of a “saver’s” option if this is a 401(k) and, oddly, holdings of MBS and even CLOs even though the saver who would otherwise hold bank deposits is most unlikely to substitute these and other obligations so far afield from cash equivalents even if small-balance savers could acquire them.

And, even if this were to make some sort of sense as a description of some liabilities, what of all the rest that banks use to float their balance-sheet boats? Home Loan Bank advances go unmentioned as do wholesale funding and bank-issued debt.

Banks are also said to invest in securities when their balance sheets are “too large,” but securities in which banks invest are of course on balance sheet. The capital advantages of some securities – e.g., sovereigns and GSEs – over others and sometimes in relationship to portfolio loans are unaddressed even though it’s a critical criterion by which banks decide whether to make loans or hold debt securities.

I hear you telling me to stop eviscerating this study and so I shall. I concur with this paper to the extent that it’s important to recognize that capital and, less dramatically, liquidity regulations are not the sole reason U.S. banks have slipped from essential to increasingly optional over the past sixty years. For one thing, also unmentioned in this paper, the U.S. regulatory framework is different than most other major markets in which similar bank capital and liquidity rules have been adopted. In most other nations, nonbanks are regulated and thus have considerably fewer regulatory-arbitrage opportunities and considerably lower market share.

For another thing, technology has significantly altered the efficiencies with which financial products are offered and distributed. The U.S. also generally adopts financial technology more quickly, has GSEs and government mortgage guarantors, and has state jurisdictions that offer particularly appealing safe harbors for all sorts of nonbank financial innovation. All of these differences combine with regulatory asymmetry to explain a lot of U.S. shadow-banking growth.

But, not all of it. The key to regulatory asymmetry is capital regulations because investors bet with their money based on return on investment and capital standards are inexorable drivers of ROI. Thus it is and nothing in the BIS paper’s methodology or model coherently or persuasively says otherwise once one reads past the abstract.