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Old Challenges in New Clothes:
Outfitting Finance, Technology, and Regulation for the Mid-2020s

Policy Session 2: What Opportunities and Risks for Financial Markets Accompany the Growing Role of Nonbanks?

Prepared Remarks
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Introduction

First, let me thank Atlanta Fed President Raphael Bostic and his team for inviting me to participate in this conference. It's an honor to be here.

Second, for those of you who don't know Better Markets, it is a nonpartisan, independent 501c3 nonprofit based in Washington DC. It has a team of experts in banking, securities, commodities, derivatives, and consumer protection. It was founded shortly after the 2008 crash to promote the public interest in the financial and economic policy making process where the interests of finance are over-represented, and the public interest is under-represented.

We're active at all the regulatory agencies, in Congress, the Executive Branch, the courts and in the media. We have participated in more than 300 rulemakings, where we are often the only non-industry organization involved. We've also been involved in dozens of lawsuits over many of those rules.

So, I come to these issues as a practitioner and public interest advocate. Our goals are social and economic justice enabled by a balanced and stable financial system that supports the real, productive economy, minimizes predatory wealth extraction activities, and enables broad-based wealth creation.

In the short time that I have, I'm going to focus on nonbank risks, rather than opportunities, and make five points.

The first point: significant unknown nonbank systemic risks.

Looking at the financial system as a whole, banks are the most highly regulated, supervised, and transparent part of our financial system. There are hundreds of bank regulators and thousands of bank supervisors. And, yet, regardless of why, they seem to fail fairly often with extremely serious consequences. Obviously recently at Silicon Valley Bank, Signature Bank and First Republic. But also, look at Wells Fargo: years of failure upon failure. And, of course, the regulators and supervisors' conduct in the years before the 2008 financial crash: again, regulation and supervision failed for years with catastrophic consequences for every American.

I don't say any of this just to bash bank regulators. I say it to highlight that -- if such risks can materialize in the most regulated, supervised, and transparent part of the financial system -- just imagine what the unknown, unregulated risks are in the nontransparent nonbank part of the system.

Frankly, it is surprising, if not shocking, how little we actually know about the nonbank financial system. The Fed's recent May Financial Stability report illustrates this. Almost every time it talks about a nonbank activity or risk, it says of course we don't really know because we don't have hardly any information.

Put differently, if we can have very big and consequential ***systemic*** surprises in the banking sector, under the noses of hundreds and thousands of regulators and supervisors, we need to be very, very worried about all that we don't know about the risks in the nonbanking sector.

The second point: this isn't the way it was supposed to be.

As everyone knows, the 2008 crash was caused by reckless risk taking – if not worse -- in the banking and nonbanking sector. And both were bailed out by the Fed, FDIC, and American taxpayers. The Dodd-Frank Act addressed both of those sectors with the intent of focusing on systemically significant financial institutions regardless of form or function. The Fed was directed to regulate systemically significant banks and the Financial Stability Oversight Council (FSOC) was created to identify risks in the nonbank sector and designate systemically significant nonbanks risks.

Systemic risks, regardless of where they originated, were supposed to be subject to regulation by the Fed. The intent was to ensure that systemically significant banks and nonbanks were similarly regulated based on their risk profiles (which, done right, should also reduce if not eliminate regulatory arbitrage).

But that didn't happen. Incredibly, today, according to FSOC, there is not one systemically significant nonbank in the US. Not one is designated as such and not one is regulated by the Fed or, really, anyone else for that matter. And that's true even in light of the facts previously mentioned: the nonbank sector is now way bigger than it was in 2008 and even bigger than it was in 2020.

And remember, confirming their systemic risks, nonbanks were all bailed out again in 2020 just like they were in 2008. Yes, this was due to a pandemic and not anyone's fault like 2008. But the 2020 pandemic shock was nonetheless the ***first live stress test of the entire post-Dodd Frank financial reform architecture.*** And it failed.

People forget that, not only did the Fed take rates to zero and engage in massive "quantitative easing" or QE, but it also revived every one of the 2008 rescue programs, for money market funds, commercial paper, asset backed securities, and mutual funds. The Fed actually added new rescue programs in 2020 for junk bond funds, private equity, and much more.

People can argue whether all that was right or wrong, necessary or not, but, regardless, it vividly highlighted the ongoing vulnerabilities, fragilities, and risks in the nonbank sector. (And, frankly, added to them by supercharging an already ballooning debt bubble and incentivizing mindless risk taking as Fed policies further decoupled price from risk and exacerbated systemic instability.)

The third point: too-big-to-fail (TBTF) is alive, well and getting worse.

It should be no surprise to anyone that TBTF is at the core of the most recent bank crisis. Not just because the non-global systemically important banks (GSIBs) were systemic. We've been saying for years that the GSIB focus is too narrow. TBTF includes what we call DSIBs: domestically systemically significant banks. Better Markets along with former Fed Governor and Vice Chair Lael Brainard (dissents here) and former FDIC Director Marty Gruenberg (dissents here) repeatedly pointed this out in dozens of rulemakings, particularly after 2017.

But bailing out or - if you prefer - rescuing DSIBs is not the only place TBTF distorts the financial system. The depositor flight to safety is another example. That only happened because people believed that the government would not let Wall Street's biggest TBTF banks fail and that, therefore, moving their deposits into those banks were safer than leaving them in DSIBs like Silicon Valley and First Republic. Plus, the only reason we had contagion is because those DSIBs didn't have viable resolution plans (aka "living wills") that allowed them to be resolved in an orderly fashion in bankruptcy or otherwise (due to widespread deregulation during the Trump administration).

Finally, the TBTF distortions and risks were involved in the First Republic disposition. TBTF JPMorgan Chase had numerous advantages that gave it an unfair competitive edge over other bidders for First Republic. I'm not saying they did anything wrong. After all, the bank was pursuing its best interests – it's not a nonprofit and it's not looking out for the public interest like Better Markets (as I have pointed out previously here). However, regardless, the bidding process wasn't a level playing field. A bank that has been an acquisition machine with the largest balance sheet in the world has inherent advantages, some legitimate and some due to subsidies it enjoys from being a TBTF bank. The result is that the biggest TBTF bank got even bigger. That is not in the public interest.

Unfortunately, TBTF is alive, well, and getting worse (and has been for some time).

The fourth point: how to change this is not a mystery.

Professor Kristin Forbes made this point yesterday when discussing monetary policy: Sometimes it's not so much trying to come up with new clothes to deal with old challenges, as the title of the conference suggests. Sometimes, the old clothes were actually pretty good. Maybe people just didn't wear them right, to run the metaphor to ground.

As I said earlier, FSOC has to do what it was created and empowered to do. With the Office of Financial Research (OFR), FSOC simply must get all the information necessary to evaluate known and emerging risks in the nonbank sector. Then, it has to identify and designate nonbank systemic risks (entities, activities or both) so that the Fed can regulate them in a way that is similar to systemically significant banks. This is not a one-size-fits-all approach, but a tailored approach based on the unique risk profile of the bank or nonbank (as the Fed was actually doing with SIFI bank regulation even before the law was changed in 2018).

Of course, regulating systemic threats isn't a mystery either. Building on a great deal of prior work, Better Markets released a Policy Brief just last week summarizing the ten actions that need to be taken to reduce systemic threats. No one will be surprised because they are all well-known – old clothes, if you will: more and better capital and liquidity; actually stressful stress testing, with public consequences; resolution plans that work and enable certainly DSIBs if not GSIBs - and systemically significant nonbanks - to be resolved in bankruptcy in an orderly fashion and in a way that doesn't involve government bailouts/support. This would be like every other company in America and consistent with the foundational rules of capitalism: take risks and be rewarded or fail if unsuccessful.

None of this is radical or, frankly, all that complicated. Yes, it will be contentious, but that is to be expected and, properly viewed, welcomed as a sign of success for the regulators and policymakers. After all, financial firms are profit and bonus maximizers while regulators are mandated to promote the public interest, ensure safety and soundness, and protect financial stability. Tension if not conflict is inevitable, especially because risk reduction usually means bonus reduction and financial protection rules prevent cost shifting from financial firms to the public.

Most importantly, we need regulators to take action as decisively and quickly to prevent the next crash as they do when trying to stop an ongoing crash. Again, read the Fed's recent May Financial Stability report. It repeatedly talks about how "decisively" they acted in response to the failures of Silicon Valley Bank and Signature Bank (in stark contrast to the grossly deficient actions and nonactions taken before those failures, as illustrated in the Fed's report on SVB and the FDIC's report on Signature Bank). But it only otherwise identifies all the ongoing risks without really proposing to do a darn thing about them. That's upside down – it's the Fed's semi-annual financial ***stability*** report after all.

The time to act decisively to prevent crashes is ***now***. One way to do that would be to enact a number of interim final rules (IFRs), which, as you know, would be effective upon publication. The Fed has the record, the power, authority, and duty to do that now.

For example, all the deregulation of DSIBs during the Trump administration was justified by baseless claims that those banks, including specifically SVB and Signature Bank, were not systemic and did not pose systemic risks. Better Markets argued in the rulemaking process that this was not true, that they were systemic, and that deregulating them would result in dangerous risks to the financial system. Then-Governor Lael Brainard said the same thing in her dissents as did then-FDIC Director Marty Gruenberg. There is now objective proof that they are systemic, and that the deregulation was in fact baseless. The Fed can and should reverse those baseless actions with IFRs asap.

Fifth, and finally, everyone has to remember that the stakes are very, very high.

This is about much more than models, regulation, deregulation, crashes, and bailouts, rinse and repeat. While studying them is academic, these are not academic issues. They impact the lives and livelihoods of all Americans.

The chart on the screen now (reprinted below) shows the unemployment caused by the 2008 crash. Using just this one metric illustrates the incredible damage that financial crashes inflict on Americans from coast to coast.

And remember that in January 2010 – when 27 million Americans were out of work due to the 2008 financial crash - Wall Street paid itself $20 billion in bonuses. That was after those bankers and financiers were bailed out by taxpayers with $700 billion in TARP money, and around $29 trillion in total used, lent, spent, guaranteed, or otherwise made available to the financial system.

There was no bailout for Main Street families. They saw Wall Street and the bankers get bailed out. They read about them paying themselves billions of dollars in bonuses while they and their neighbors were thrown out of work, and some lost their homes. Main Street families felt that. They lived that. And, yes, they remember that.

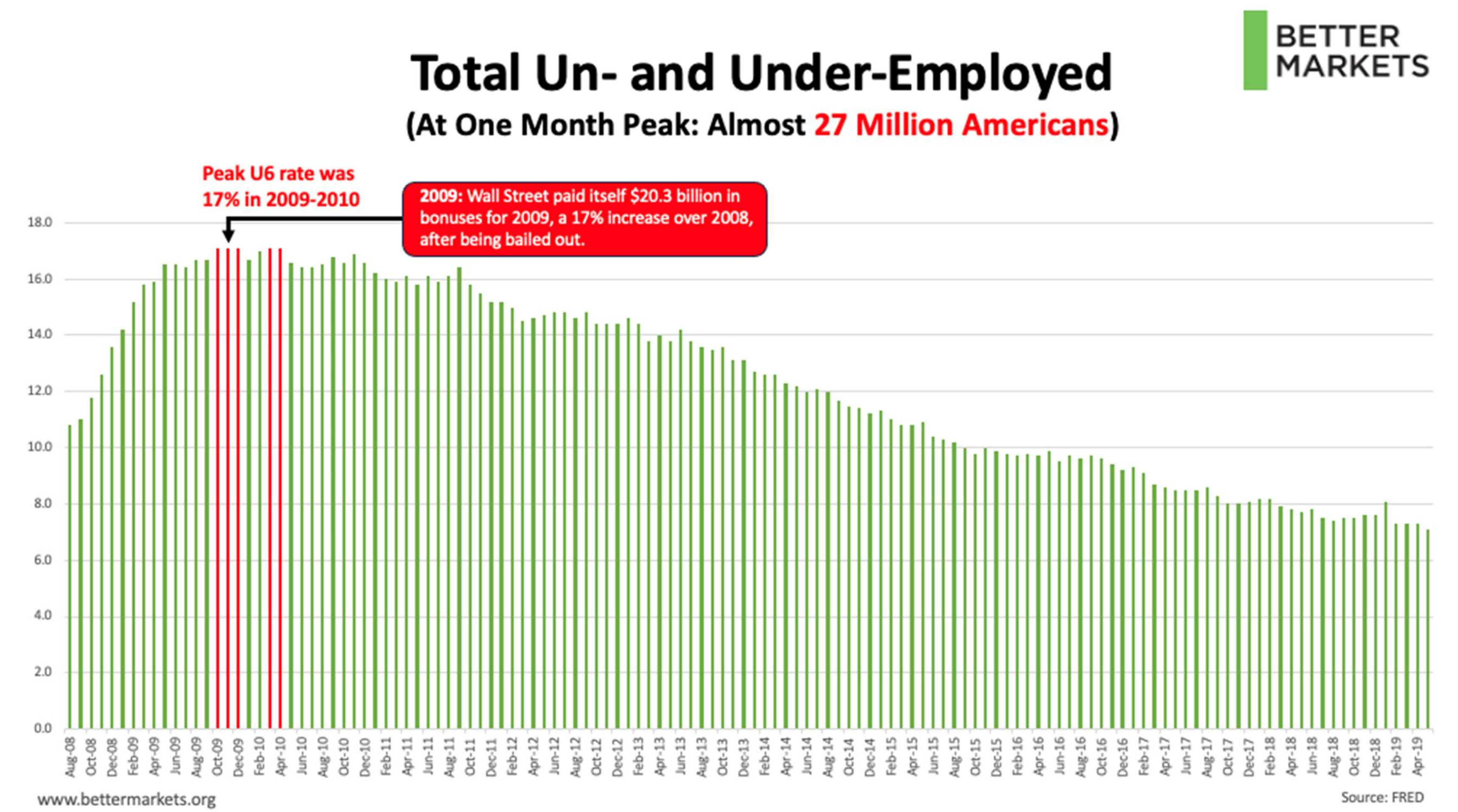
Remember also that even a so-called soft landing is still going to land very, very hard on millions of Americans, their families, and communities. And, sure, a low unemployment rate is much better than a high one but remember that the unemployment rate for each of those millions of Americans who are unemployed is 100%, with dire consequences for most of them.

But that's not all the costs and consequences of not properly regulating and supervising the risks from nonbanks and banks. These issues also directly impact our democracy. The faith, trust, and confidence of the American people in their government, legal system, rule of law, and government officials are at stake with the issues we are talking about at this conference.

Bailouts and favorable treatment for the wealthy and well-connected destroys confidence and trust. Not just in regulators, but the entire government and, yes, in democracy itself. I don't have time to talk about this at the length it deserves, but I urge you all to read Martin Wolf's new book "The Crisis of Democratic Capitalism." I don't agree with everything he says, but he starkly illustrates what's at stake when the special interests – including especially from TBTF banks and nonbanks - are put above everyone else.

So, yes, look at the opportunities nonbanks may create for financial markets, including importantly the possibility of competition, lower prices, and better services and products. But remember that the costs and consequences of not properly regulating bank and nonbank risks aren't just crashes and crises, which are bad enough. People, real people, with families and hopes and dreams, are directly impacted by your actions, as are their faith, trust, and confidence in their government.

Thank you.



BETTER MARKETS
Total Un- and Under-Employed
(At One Month Peak: Almost 27 Million Americans)
Peak U6 rate was 17% in 2009-2010
2009: Wall Street paid itself $20.3 billion in bonuses for 2009, a 17% increase over 2008, after being bailed out.
www.bettermarkets.org
Source: FRED