Jay Powell, GSIBs, Christmas Eve Massacre

“I think that the overall level of our capital, particularly at the largest firms, is about right. I’m open to evidence that there are problems with that. I don’t see U.S. banks having difficulty competing, particularly internationally. They seem to be competing very well. They seem to be profitable…. Their stock prices seem to be fine. So, in terms of the surcharge in particular, it’s one of a bunch of pieces. But I would say the overall level, I think, is just about right.” – Federal Reserve Chairman Powell during his recent testimony before the House Financial Services Committee. Source: Capital Alpha Partners.

Twenty-nine Members of Congress have written to Powell, questioning the costs and capital requirements imposed on the large banks. In America there are eight huge banks known as G-SIBs. The acronym means “globally systemically important banks.” Twenty-one additional huge banking enterprises that are non-US jurisdictions bring the worldwide total to 29 G-SIBs. The American G-SIBs are Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JP Morgan Chase, Morgan Stanley, State Street, and Wells Fargo.

Readers can learn more about G-SIBs here:

• "Global systemically important bank (G-Sib)," https://www.risk.net/definition/global-systemically-important-bank-g-sib
• "The G-SIB framework – Executive Summary," https://www.bis.org/fsi/fsisummaries/g-sib_framework.htm
• "2018 list of global systemically important banks (G-SIBs)," http://www.fsb.org/2018/11/2018-list-of-global-systemically-important-banks-g-sibs/

Here is why G-SIBs and rules applied to them contributed to the stock market crash and to money and bond market volatility at the end of last year.

The way the rules work, G-SIBs are encouraged to make market changes in their portfolios at certain reporting periods. One of those changes is to temporarily shrink the size of the bank in order to lower a regulatory cost. The technical details are described in the citations above. This rule is set to change in 2021. Numerous types of market transactions are used to accomplish a temporary size shrinkage. Repo is one of them.

At yearend 2018 G-SIBs rationally performed the shrinkage but shocked financial markets in doing so. Most investors don't delve deeply into this arena and were therefore scared by the December market selloff and its aftermath.

This is just one of many examples of a liquidity crunch scare and market gyrations induced by rules and regulations rather than by traditional market forces.

At yearend the repo rate for an overnight transaction spiked. At one point it was 5% instead of about 2%. There were a few days of the run-up to the spike and a few more as it unwound. The stock market waterfall coincided with this period, as panicked investors fled the markets for emotional reasons, fearing a liquidity crunch.

At the end of December, the credit spread between HYG and GT10 was 314 basis points. On the September 2018 close it had been 234. It narrowed in January.

As 2018 drew to a close, Moody’s Baa Corp versus GT10 was 245, as opposed to 183 at end of September. It is lower today.

While T-bills and other similar riskless rates didn’t change much during the yearend period, other riskless rate measures changed dramatically. That is how we could narrow the culprit to a rule and not a liquidity event.

SOFR, the secured overnight financing rate, is a developing benchmark. It was 300 basis points at yearend. It was 216 at the end of September and is about 240 today. Twenty-five bps of the difference between September and today is attributable to a quarter-point hike by the Fed. The other 60 bps is due to the rule change, that is, to the bank shrinkage effect.

From this metric we can estimate the cost of this rule. Here goes.

A single basis point cost on $1 trillion is $100 million annually. Divide that by the number of days in a year, and the daily cost for each trillion dollars is $280,000. At yearend, for one day of the SOFR distortion, we multiply by 60 bps to get about $17 million cost for a single day for American banks. Remember, there were also days running up to peak, followed by days running off the peak, as G-SIBs unwound their shrinkage trades.

How many trillions are involved worldwide? We can only guess, as there are 29 G-SIBs, whose direct and notional derivatives balances are estimated to total between $200 and $400 trillion. A back of envelope guess takes the global cost into the billions.

Bottom line: It cost a lot to comply with a rule that could be adjusted to smooth out the spikes. We can see the spike effects in the composition of the Fed’s balance sheet at each quarter end and yearend.

Second bottom line: This is highly technical stuff, and most investors don’t understand it. So they panic, which is why the stock market crashed and the bond market hiccupped in December. It wasn’t because default risk actually rose; the selloff was triggered by a rule.

Third bottom line: Knowledgeable investors took advantage of the whipsaw, while panicked investors lost trillions in market value. We can only guess at negative economic costs from negative wealth effect shocks.

Fourth bottom line: Investors didn’t see much explanation of these developments from some of the TV talking heads, many of whom don’t understand the intricacies of the transactions involved. Others have trouble explaining them on TV or radio or in Twitter message sound bites, especially given time and media constraints. Read through the tutorial links above to discern how hard it is to put this issue in layman’s terms.

Fifth bottom line: The 29 G-SIBs are the global giants of the world’s banking system. All the rest are nice folks, but they really don’t move the markets. They are the Lilliputian banks. The 29 are the Brobdingnagian giants (*Gulliver’s Travels,* https://en.wikipedia.org/wiki/Gulliver%27s_Travels). Because they are governed by their country’s national central banks, they form the linkages among all major central banks. To understand global central banking one must understand the GSIBs and how they interconnect with each other.

The Christmas Eve Massacre was rough on investors. Our US ETFs rode through the waterfall and V-shaped recovery without suffering panic selling. We’ve had a very good start to 2019. Recently we raised some cash reserve, as markets have galloped away from the Christmas Eve massacre and may have gotten ahead of valuations.

As for our opening quote from Chairman Powell, we think he is correct: The problem isn’t inadequate capital for American banks; the problem is an ill-constructed rule.

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