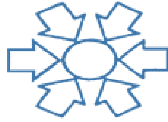

FedFin Client Report

Tuesday, November 10, 2020

Fed Financial-Stability Report: Nonbanks, Investment Funds, Treasury Market, Climate Risk Set for Reform Agenda

Client Report: **SYSTEMIC89**

Executive Summary

In this report, we go in depth into the forward-looking financial-policy implications of the Fed's latest financial-stability report. Press focused on Fed findings germane to the pandemic and fiscal policy, but the report as always is an important guide to what the Fed and other U.S. regulators will do as the pandemic continues and in its wake. Indeed, in a statement accompany the report, Gov. Brainard highlighted several near-term actions warranted by the report, focusing in particular on the need to address recent corporate mutual-fund outflows, Treasury-market structural reform, and climate risk. The May report (see *Client Report* **SYSTEMIC88**) forecast action on MMFs and mutual funds not only repeated in this report, but also emphasized now as the Fed continues work with the FSB and formalizes the U.S. initiatives it will launch when a new FSOC in the Biden Administration is seated next year. In addition to a new focus on the Treasury market, a new issue in yesterday's report is alarmist language about structural risk in the life-insurance sector. The Fed in the past has supported SIFI designation for top insurers and may pursue this again or consider activity-and-practice standards with FSOC despite difficulties enacting them via state insurance regulators.

As we anticipated in our "green" issues brief, the new report also takes a strong stand on climate risk, for the first time elevating it to a U.S. financial-stability concern. Indeed, the report stipulates that Fed supervisors expect banks to measure, manage, and mitigate climate risk – a first also in light of prior Fed statements that this is already done by virtue of existing credit-risk requirements. However, reflecting Chairman Powell's comments last week, the report also describes challenges to measuring and managing physical or transitional climate risk. However, it details those in the real-estate sector, perhaps signaling near-term Fed work targeted in this area.

In addition, the report reiterates the need for NBFI reform, focusing in particular on risk at institutional prime MMFs due to problematic redemption gates and on hazards to nonbank mortgage servicers if forbearance risks emerge and refinancings slow.

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Analysis

Current systemic vulnerabilities:

- Although risk premiums are in historic ranges, asset prices are subject to significant decline if investor sentiment or economic conditions fall. CRE and farmland prices are especially worrisome, as are energy and hospitality assets. Leveraged loans are now less concerning.
- Credit quality faces significant downward pressure, but sound capital permitted banks to continue to lend in key sectors and thus buffer macroeconomic stress.
- Business and household leverage is troublingly high. Stress so far has been mitigated by government support and low rates but significant vulnerabilities are nonetheless evident in LMI households. Overall risk due to household debt poses potential risk to the financial system even though mortgage risk remains low.
- Student debt is problematic but presents low systemic risk.
- Corporate debt, including leveraged loans, is worrisome, but within norms; small-business debt is considerably more risky.
- Banks are stressed, but remain well-capitalized; broker-dealer leverage is also low. In contrast, life-insurance and hedge-fund leverage is very high.
- Bank funding risk is low; in contrast, money funds and fixed-income mutual funds remain vulnerable. Indeed, prime MMFs saw the same level of outflows in March as they did in 2008.
- Nonbank mortgage servicers benefited from Ginnie and FHFA facilities and the refi boom, but remain at risk.

Looking in depth at the March turmoil, this report concludes that:

- Foreign investor sales of Treasuries contributed to market turmoil, with many Treasury sales coming from official institutions (e.g., central banks).
- Relative-value hedge funds also precipitated the dash for cash. Although insufficient data make analysis here more challenging, proxy indicators show both significant sales and ongoing dealer support for hedge funds through the crisis.
- MREITs also sold Treasuries due to the need to meet margin calls with negative feedback loops accelerating both margin calls and Treasury liquidation. Fed facilities resolved growing stress.
- Stress in high-speed market-making also proved problematic, but more analysis is necessary.
- Dealer balance sheets proved resilient, in part due to Fed facilities, but work continues on ways to intermediate the Treasury market without reliance on primary dealers in light of growing issuance.
- CCPs managed pandemic risk, but ongoing volatility poses continuing threats and higher cash and collateral requirements could undermine market liquidity.
- CLOs fundamental have improved, but the sector remains "too weak."

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- Brexit risk could renew systemic challenges.
- China poses an array of structural financial-market risks. EMEs also remain vulnerable. U.S. banks are exposed to risk not just due to their own exposures to China and EMEs, but those to U.S. companies dependent on supply chains related to them.

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