FedFin Client Report

Monday, May 10, 2021

Fed Stability Fears Presage MMF, FBO Regulation

Client Report: SYSTEMIC91

Executive Summary

In this report, we assess the details of the Fed's most recent financial-stability report, focusing on policy and regulatory ramifications with near-term strategic impact. As always, the Fed's language is muted lest any clear expressions of alarm spook financial markets. This report nonetheless signals a change in which the U.S. central bank publicly recognizes that strong banks do not necessarily ensure a strong financial system. In her statement accompanying the report, Gov. Brainard emphasized the benefits of counter-cyclical capital buffers in response, but we believe the Board and FSOC will instead pursue NBFI reform through an array of channels rather than a bank-focused macroprudential strategy. Echoing Gov. Brainard earlier this year, the report also takes a strong stand on specific reforms to reduce MMF and open-end fund liquidity risk. Little noticed in the report are strong suggestions that, as signaled earlier this year (see Client Report **ELECTION25**), the Fed will revive proposed liquidity requirements for the branches and agencies of foreign banks.

Analysis

We do not here summarize key data in the Fed's lengthy report, focusing instead on findings with policy impact. These include:

- A significant rise in hedge-fund and over leveraged financial entities warranting increased transparency (i.e., more timely data and disclosure requirements). The Archegos discussion highlights risks a small entity created for large banks due to concentrated holdings, but the Fed's policy remedy appears to be more disclosure, SEC regulation, and NBFI regulation, not additional bank standards.
- Bank lending to NBFIs represents a potential systemic-risk channel, reaching record levels late last year, with credit lines exacerbating leverage.

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Low delinquency levels are in good part attributable to FRB and Treasury backstops. No policy action in response to these concerns is delineated, although the report notes ongoing efforts to address MMF and open-end fund risks. Repeating a recent speech of Gov. Brainard, the report says that, "properly calibrated" swing pricing, a minimum balance-at-risk, or capital buffers would significantly reduce run risk. The report also details other financial instruments at significant run risk, largely repeating the analysis of the November, 2020 report (see *Client Report* **SYSTEMIC89**).

- Prior FRB concerns about life-insurance companies are ramped up in this report. However, as before, the Fed proffers no recommendations for action.
- There is a new discussion of the ability of FBOs to transmit funding risk into the United States, posing significant risk to the dollar-clearing market. The Fed notes that liquidity requirements for IHCs (see FSM Report **SIFI34**) improved FBO resilience, but it fears that branches and agencies pose systemic challenges.

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