Tuesday, November 9, 2021

Fed Ramps Up Worries, Outlines Preferred MMF Option

Client Report: SYSTEMIC92

Executive Summary

Late yesterday, the Federal Reserve released its most recent financial-stability report. As in its predecessor earlier this year (see *Client Report* **SYSTEMIC91**), this report takes a cautious view, counting on continuing bank resilience to counteract old worries, such as asset-price bubbles, along with containing at least some new fears. These now include meme-driven equity market volatility, Chinese leveraged debt, and emerging-market fragility. In this report, we assess the policy implications of the Fed's findings without going into detail on data or methodology. Surprisingly, in light of the recent FSOC report (see *Client Report* **GREEN11**), climate risk is now less of a high-profile Fed systemic concern, with the Board saying its planned actions are "broadly aligned" with FSOC recommendations. Perhaps the most concrete remedy outlined in the report pertains to MMF resilience, with the Fed reiterating its preference for some form of swing pricing, minimum balances at risk, and/or capital buffers.

The report also emphasizes that deteriorating public health could well strain highly-leveraged markets subject to significant credit risk (e.g., nonfinancial borrowers) and highly-leveraged nonbank financial companies such as life insurers and hedge funds. The Fed also details an array of risks resulting not only from a sudden spike in interest rates, but also from even gradual reductions due to the impact this would have on leveraged household balance sheets.

Analysis

Key findings include:

- Asset-Price Bubbles: Asset prices are found to be worrisomely high, even though the overall credit quality of outstanding bonds has improved since the Fed's May report, judged by the credit ratings banks are barred from using to reach similar judgments. Although leveraged-loan spreads are down, the Fed seems far less concerned than in the past about this problematic sector. Speculation is said not to lie behind recent house-price increases.
- Retail Investors, Social Media, and Equity Trading: These are new Fed concerns sparked by last spring's Robinhood incidents. The report draws no conclusion about long-term financial-stability impact, urging only monitoring. However, this discussion suggests support for at least some aspects of the SEC's ongoing work to address digital-asset activities (see *Client Report* **INVESTOR19**), especially with regard to internal risk management. Despite similar concerns re recent cryptoasset volatility, the Fed report does not fear financial-stability risk in the near

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

term from retail trading, focusing instead on longer-term issues posed by stablecoins (see below).

- Foreign Treasury-Market Investment: This is another new concern, but the Fed largely details activity in this sector without drawing conclusions from it. This is presumably due to the parallel work by the Inter-Agency Working Group, whose report was also released on Monday.
- Financial-Sector Leverage: The Fed reiterated its long standing concerns about life-insurance and hedge-fund leverage. The Fed is also concerned with growing illiquidity at life insurers.
- MMFs and Open-End Funds: Similarly, the latest report reiterates Fed funding-risk concerns for these products, now citing the FSB's latest reform report (see FSM Report **MMF18**). The Fed says several options cited by the FSB are "promising," specifically noting swing pricing, minimum balance at risk, and capital buffers. Cash-management and similar investment funds also warrant reform akin to that imposed on prime funds.
- Stablecoins: The report reiterates the systemic concerns raised in the PWG report last week (see *Client Report* **CRYPTO21**).
- CCPs: The report reiterates concerns about margin illiquidity initially laid out by the FSB at the end of last year (see *Client Report* **NBFI**) and most recently reiterated by IOSCO and other global regulators. Collateral transformation is also cited as a key concern, noting that low rates and high bank reserves now mitigate a risk that may prove very problematic under stress in different scenarios. Treasury-market reform efforts are also aimed at collateral transformation.
- LIBOR Transition: Board concerns are reiterated along with its SOFR preference.

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