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October 19, 2020

COVID-19 and Financial Stability: SEC Staff Report and Roundtable on Credit Market Interconnectedness

[32842]

October 19, 2020 TO: ICI Members
Investment Company Directors
ICI Global Members
ICI Global Regulated Funds Committee
SEC Rules Committee SUBJECTS: Bank Regulation
COVID-19
Exchange-Traded Funds (ETFs)
Financial Stability
Money Market Funds
Operations
Portfolio Oversight
Risk Oversight RE: COVID-19 and Financial Stability: SEC Staff Report and Roundtable on Credit Market Interconnectedness

Securities and Exchange Commission staff recently issued a report on the interconnectedness of the US credit markets and the effects of the COVID-19 economic shock[1] and held a follow up roundtable on these issues.[2] The purpose was to identify and place in context key structural- and flow-related interdependencies in the US credit markets and areas of stress revealed by the COVID-19 shock.

The staff encourages members of the public to submit feedback on the report and roundtable at Credit_Market_Interconnectedness@sec.gov.

The below summary highlights the key issues discussed in the report and roundtable.

SEC Staff Report on Interconnectedness and the Effects of the COVID-19 Economic Shock

The staff report focuses on the interconnections among the various U.S. credit markets, including the actions of issuers, intermediaries, and holders of credit, and analyzes their interconnections within the larger financial system. Overall, the report concludes that the financial system and the flow of credit are not monolithic, but are an interconnected collection of markets, each serving different aspects of the general economy.

The report specifically examines six credit market segments covering $44 trillion of outstanding credit, including:

- short-term funding,
- corporate bond,
- leveraged loans and CLO,
- municipal securities,
- residential mortgage and other consumer lending, and
- commercial mortgage.

Using the COVID-19 economic shock in March 2020 as a case study, the report describes stresses that developed in the credit market as market participants' preferences shifted. In particular, the report finds that COVID-19 induced stress in three ways:

- Short-term funding stresses caused by suddenly elevated demand for liquidity: the report links this stress to a combination of how market participants organized their businesses and how these participants reacted in the face of increased risk aversion, funding costs, margin requirements, haircuts, and other disruptions.

- Market structure/liquidity driven stresses caused by elevated demand for intermediation in the context of constrained capital and risk limits: the report states that stresses were most apparent in markets that are principally dealer-intermediated, including markets for municipal securities, corporate bonds, and short-term funding. While many of these markets saw increased notional trading volume, trading costs were exceptionally elevated and volumes did not keep up with the surge in demand.

- Long-term credit stresses emanating generally from the immediate and anticipated impacts of the COVID-19 economic shock: the report observes that these stresses may still be unfolding, especially in the corporate bond, municipal securities, commercial real estate and leveraged loan markets.

The SEC's press release highlights the following as "key takeaways" from the report:

- The US credit markets, in size, structure and function have changed significantly since the 2008 global financial crisis.

- The credit markets are highly interconnected, which can both accelerate risk transmission and facilitate risk absorption.

- The ability of intermediaries to absorb significant, rapid shifts in investor sentiment (*e.g.*, a "dash for cash") is limited in absolute terms and may become more limited as spreads widen and volatility increases during periods of stress and uncertainty.

- Due to the interconnected nature of our credit markets and the size and scope of the COVID-19 shock, it was insightful, prudent and, perhaps, essential that the actions of the Federal Reserve and the CARES Act were multi-faceted and immediate. Those actions were instrumental in ameliorating stress in the credit markets, particularly the short-term funding markets.

- The combination of the Federal Reserve's intervention and the CARES Act also was extremely important in stabilizing prices (*e.g.*, housing prices) and sustaining economic activity (*e.g.*, consumer spending), which in turn added stability to the credit markets.

- Banks and the banking system have been resilient to the COVID-19 shock to date notwithstanding their exposure to several trillions of dollars of residential and commercial mortgages and leveraged loans to corporations.

Roundtable on Interconnectedness and Risk in US Credit Markets

On October 14, the SEC held a roundtable to discuss the staff report from the market and regulatory perspectives.

- Panel 1: Market Perspective included Sumit Rajpal (SEC), David Finkelstein (Annaly Capital Management), Dawn Fitzpatrick (Soros Fund Management), Steven Goulart (MetLife, Inc.), Barbara Novick (BlackRock), and Thomas Wipf (Morgan Stanley).

  Panelists generally agreed that the Federal Reserve Board response to the COVID-19 crisis and resulting dash for cash was timely, efficient, and signaled readiness to step in. Panelists discussed the effect of the crisis on short term funding markets, money market funds, bond funds, and ETFs. While panelists were generally optimistic about long term prospects, some suggested reforms such as requiring dealers and/or money market funds to have countercyclical buffers, creating a standing Treasury repurchase facility, and expanding central clearing to avoid a repeat of the crisis on credit markets in the future.

- Panel 2: Fireside Chat included SEC Chairman Jay Clayton, Mark Carney (UN Special Envoy on Climate Action and Finance), Gary Cohn (former Director of the National Economic Council), Glenn Hutchins (North Island), and Lorie Logan (Federal Reserve Bank of New York).

  Panelists discussed how the growth of the Treasury market and reforms undertaken after the 2008 global financial crisis each may have impacted market reaction to the COVID-19 crisis, as well as the role played by ETFs and money market funds. Some panelists focused on the relatively high speed of trading in relation to the slower speed of clearing and settlement as an issue for further review. Panelists also discussed whether regulatory and other constraints on dealers affected their behavior during the crisis and whether other actors could fill gaps to provide liquidity to the market.

- Panel 3: Regulatory Perspective included S.P. Kothkari (Director, SEC Division of Economic and Risk Analysis), Tobias Adrian (International Monetary Fund), Natasha Cazenave (Autorité des Marchés Financiers), Andreas Lehnert (Federal Reserve Board), and Brent McIntosh (Treasury Department).

  Panelists discussed the Federal Reserve response to COVID-19, including the advantage gained by being able to pull some programs “off the shelf” from the 2008 global financial crisis. Panelists lauded the international cooperation efforts. With respect to the role money market funds played in the crisis, panelists stated that money market funds are systemic and interconnected in nature and required intervention in the COVID-19 crisis. Panelists largely agreed that the Federal Reserve’s market interventions did not create moral hazard for the market because the cause of the crisis was a once-in-a-lifetime pandemic.

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endnotes

[1] *See* U.S. Credit Markets Interconnectedness and the Effects of the COVID-19 Economic Shock (Oct. 5, 2020), *available at* https://www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf. The report states that it "is one of several elements of the SEC's risk and market monitoring efforts," but does not explicitly reference the SEC's COVID-19 Market Monitoring Group, which had been tasked to review interconnectedness. *See* ICI Memorandum No. 32464, *available at* https://www.ici.org/covid19/latest/memo32464.

[2] *See* the event webpage for the roundtable, *available at* https://www.sec.gov/page/roundtable-interconnectedness-and-risk-us-credit-markets. The webcast of the roundtable is *available at* https://www.sec.gov/video/webcast-archive-player.shtml?document_id=101420-risk-roundtable.
