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July 22, 2020

COVID-19 and Financial Stability: Updates from the FSB and SEC

[32630]

July 22, 2020 TO: ICI Members
Investment Company Directors
ICI Global Members
ICI Global Regulated Funds Committee
SEC Rules Committee SUBJECTS: COVID-19
Financial Stability
Money Market Funds
Operations
Portfolio Oversight
Risk Oversight RE: COVID-19 and Financial Stability: Updates from the FSB and SEC

Policymakers within and outside the United States are reviewing the impact of the COVID-19 pandemic on the financial system and related issues from a financial stability perspective. This memorandum briefly describes recent statements by the Financial Stability Board (FSB) and its Chair, Randal Quarles, Securities and Exchange Commission (SEC) Chairman Jay Clayton, and the SEC COVID-19 Market Monitoring Group (SEC MMG) regarding these issues and related workstreams.

Financial Stability Board: Letter and Report to G20 Finance Ministers and Central Bank Governors

As is customary, FSB Chair Quarles transmitted a letter and report to the G20 Finance Ministers and Central Bank Governors in advance of their July 18 meeting.[1] As the letter states, the response to the COVID-19 crisis provided evidence that financial reform can improve economic resilience and markets are responsive to quick and decisive policy actions.

While noting actions that global policymakers took in response to COVID-19, the letter identifies liquidity stress as a continuing risk, along with the potential return of market volatility and pricing disconnects between the market and economic fundamentals. Regarding the non-bank financial intermediation (NBFI) sector, the letter noted risks related to liquidity mismatches, leverage, and interconnectedness, and investor behavior related to certain funds that are treated as cash equivalents during economic calm but not during crisis. While extraordinary central bank interventions placated capital markets, which remained open and enabled firms to raise new and longer-term financing, in Chair Quarles's view, such measures should not be required. The letter emphasizes that “[u]nderstanding risk, risk transmission, and policy implications for the NBFI sector is more important than ever.”

The letter also noted that the FSB had formed a group on NBFI, composed of senior leaders from market regulators, macroprudential authorities, and international organizations. By the November G20 Leaders’ Summit, this group will carry out a holistic review of market turmoil during March 2020, drawing on workstreams underway at standard setting bodies. In addition, the FSB has begun mapping the connections between traditional banking and non-bank sectors in a cross-border setting. This combined work aims to clarify the various points of vulnerabilities and risk amplification and transmission in the financial system and will inform future steps of the FSB.

In an accompanying report released to the public on July 15, the FSB discussed the financial stability implications of the COVID-19 pandemic and policy measures authorities took in response to it.[2] The report lauded the ability of the financial system to function well despite challenging financial and operational conditions. Specifically, the report notes that capital markets, with regulatory intervention, remained open and enabled firms to raise new and longer-term financing. Authorities took a wide range of measures to sustain the supply of credit to the real economy and to support financial intermediation, according to the FSB. The measures taken by central banks to calm markets, however, were temporary and not aimed at addressing potential underlying vulnerabilities.

The report also highlighted areas of the financial system that were or remain areas of concern for financial stability, including:

- Outflows from open-ended funds, including ETFs that invest in less liquid assets, prime institutional US money market funds (MMFs), and similar non-US MMFs, during March and April.
- The deterioration of credit quality for both financial and non-financial corporates. The report predicted the demand for credit to rise as corporate revenues remain below what would be needed to cover expenses, and existing cash reserves are run down. Deteriorating credit quality also calls attention to the potential procyclical effects of credit rating downgrades.
- The risk of further liquidity stress. The report noted that market participants may withdraw funding from higher risk sectors due to risk aversion, balance sheet constraints, or operational issues and seek financial safe havens, placing renewed demand on market and funding liquidity.

While noting improvements to the financial markets since March, the report recommended that in an environment of declining credit quality and uncertainty about the recovery, authorities should remain vigilant and continuously calibrate their policy responses to enable financial resilience and support to the real economy. The report recommended further study of liquidity risks in the global financial system. The FSB also recommended that lending support should remain in place as needed to support the economic recovery.

Echoing Chair Quarles’s letter, the report stated that “[i]t will be important to consider the nature of vulnerabilities in NBFI in relation to the liquidity stress and the implications of the extent and nature of central bank liquidity support, and to better understand the resilience of the NBFI sector.” Like the letter, the report mentioned the FSB’s work on an “interconnectedness map showing interlinkages among different parts of the NBFI ecosystem and with banks," which will inform the FSB workplan on NBFI going forward.

SEC: Clayton Remarks and SEC MMG Observations

On July 15, the SEC released opening remarks that Chairman Clayton delivered at a closed meeting of the Financial Stability Oversight Council the previous day.[3] Chairman Clayton noted that the "pipes and plumbing" of the securities markets continued to function during the COVID-19 crisis. He observed no systemically adverse operational issues with respect to key securities market infrastructure. He reported that much of the regulatory relief the SEC issued in March is no longer necessary, but the agency will continue to monitor and provide additional relief and guidance as needed.

Chairman Clayton also provided an update on ongoing SEC MMG initiatives.[4] As for the group's longer-term initiative to identify and analyze significant channels of risk exposure and risk transfer in the capital markets and their interaction with the broader financial system, the SEC MMG will select portions of the capital markets and identify which participants, activities, and linkages act or function as the originators, transmitters, amplifiers, absorbers and ultimate holders of market risk. As an example, Chairman Clayton cited an analysis of the residential mortgage market. He also commented that the SEC MMG's work "has dovetailed well with some similar efforts in the international realm, including among the Financial Stability Board's Standing Committee on Assessment of Vulnerabilities (FSB SCAV) and the International Organization of Securities Commissions (IOSCO)."

Chairman Clayton also noted another SEC MMG initiative to analyze the potential risks and effects of investment strategies and mandates that are subject to mechanistic rules, guidelines or restrictions on holdings of assets (*e.g.*, by reference to credit ratings or downgrades). On the same day as Chairman Clayton's speech, the SEC MMG published select observations on its work exploring "whether credit assessments and credit rating agency downgrades—and market anticipation of, and responses to, those ratings actions—may (1) contribute to negative procyclicality in certain circumstances and (2) have implications for financial stability."[5] The SEC MMG cautioned that analogies between the role of rating agencies in the current COVID-19 crisis and the 2008 global financial crisis should be approached with caution, given the substantially differing economic conditions and different assumptions and methodologies used by rating agencies in that period.

The SEC MMG observed that ratings downgrades generally are lagging indicators of cost of debt capital, which is driven by a range of factors. Observable bunching just above and below the investment grade level may be attributable to various macroeconomic trends, including policy, regulatory, and investor choices. When examining the effects of reliance on ratings, including procyclicality of ratings downgrades, the SEC MMG recommended that observers consider the broad spectrum of credit markets and institutional investors active in these markets—including insurance companies and pensions, among others.[6] Finally, the SEC MMG identified the potential procyclical effects of credit ratings used in bilateral specialty finance as "worthy of continued monitoring."

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endnotes

[1] *See* Letter of FSB Chair Randal Quarles to G20 Finance Ministers and Central Bank Governors (Jul. 14, 2020), *available at* https://www.fsb.org/wp-content/uploads/P150720-1.pdf.

[2] *See* COVID-19 Pandemic: Financial Stability Implications and Policy Measures Taken (Jul. 2020), *available at* https://www.fsb.org/wp-content/uploads/P150720-2.pdf.

[3] *See* Chairman Jay Clayton, Remarks to the Financial Stability Oversight Council (Jul. 15, 2020), *available at* https://www.sec.gov/news/public-statement/clayton-fsoc-2020-07-14.

[4] The SEC established the MMG as temporary, senior-level group to (1) develop Commission and staff analyses and actions related to the effects of COVID-19 on markets, issuers and investors—including in particular long-term Main Street investors, and (2) respond to requests for information, analyses and assistance from regulators and other public sector partners on market matters arising from the effects of COVID-19.

[5] *See* Credit Ratings, Procyclicality and Related Financial Stability Issues: Select Observations (Jul. 15, 2020), *available at* https://www.sec.gov/news/public-statement/covid-19-monitoring-group-2020-07-15.

[6] The SEC MMG noted that registered investment companies (including ETFs) account for approximately: 21% of the U.S. and foreign corporate bonds market, 14% of the U.S. and government agency securities market, 29% of the U.S. municipal securities market and 25% of the commercial paper market.