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December 20, 2021

FSOC Issues 2021 Annual Report, Considers Climate Risk and LIBOR Transition

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TO: ICI Members
Investment Company Directors
ICI Global Members
LIBOR Transition Working Group SUBJECTS: Alternative Investments
Bank Regulation
Closed-End Funds
COVID-19
Derivatives
Disclosure
ESG
Exchange-Traded Funds (ETFs)
Financial Stability
Fixed Income Securities
Investment Advisers
Money Market Funds
Municipal Securities
Trading and Markets
Unit Investment Trusts (UITs)
Valuation RE: FSOC Issues 2021 Annual Report, Considers Climate Risk and LIBOR Transition

At a public session on December 17, the US Financial Stability Oversight Council (FSOC or Council) issued its 2021 annual report to Congress.[1] As required by statute, the FSOC report addresses significant financial market and regulatory developments, provides an assessment of those developments on the stability of the financial system, and identifies potential emerging threats to US financial stability.[2] This memorandum briefly describes the contents of the FSOC report and highlights the recommendations that may be of particular interest to the regulated fund industry.[3]

In other actions during the December 17 public session, FSOC voted to establish a Climate-related Financial Risk Committee (CFRC), which will serve as a venue for the staffs of Council members and member agencies to collaborate and share information regarding potential climate-related risks.[4] The Council also received an update from staff of the Federal Reserve Board on the transition from LIBOR, including the cessation of new U.S. dollar LIBOR transactions after December 31, 2021.

During an executive session, FSOC received the following updates: from Securities and Exchange Commission Chair Gensler, an update on forthcoming proposed SEC rulemakings; from staff of the federal banking agencies, an update on the Crypto-Asset Policy Sprint Initiative; and from Treasury staff, an update on ongoing work on climate-related financial risks.[5]

Content of the FSOC Report

Chapter one of the report begins with a statement of support from the FSOC principals and proceeds substantively as follows:

- Chapter two, the executive summary of the report, observes that while the "acute financial crisis that occurred at the onset of the pandemic in 2020 has moved farther into the rear-view mirror," the Council remains focused on financial system vulnerabilities "induced or made more salient by that episode." It notes certain episodes of "unusually high volatility" in the financial markets, asset valuation pressures, and supply chain problems or rising prices occasioned by the rapid pace of economic recovery. Chapter two emphasizes the three key priorities identified by the Council earlier this year: climate change; vulnerabilities in nonbank financial intermediation (NBFI); and resiliency of the US Treasury market.
- Chapter three of the report provides a lengthy update on financial developments with respect to: household finance; nonfinancial business finance; government finance (including a call out box discussing work of the Inter-Agency Working Group for Treasury Market Surveillance on Treasury market resilience); financial markets; financial institutions; financial market structure, alternative reference rates, and financial innovation; and global economic and financial developments. The chapter includes discussion of registered funds—money market funds (MMFs), mutual funds and exchange-traded funds—and a call-out box on the Council's evaluation of risks posed by MMFs, mutual funds, and hedge funds.[6]
- Chapter four of the report details regulatory developments and FSOC activity since the 2020 annual report and includes a call-out box on climate-related financial risk.
- Chapter five of the report discusses the vulnerabilities identified by the Council, highlights key actions taken to mitigate risks, and makes recommendations for addressing the risks. It includes a call-out box on stablecoins.

Recommendations of Particular Interest to Members

Investment Funds

The report states that redemption risk in certain open-end funds "may lead to asset liquidations that contribute to disruptions in important financial markets" and that "[t]he level of this risk is a function of, among other things, the liquidity of the underlying assets, the widespread practice of settling investor redemptions within two days, the effectiveness of the fund's management of its liquidity, and the potential for an investor to enjoy a first-mover advantage." It notes that the Council "has focused in particular on the question of whether the structure of open-end funds results in greater selling pressure than if investors held the fixed-income instruments directly."

The Council formed an Open-End Fund Working Group this year. The report explains that the working group "is reviewing the role of open-end funds in the financial stability disruptions of 2020, and the extent to which intense redemptions and asset liquidations by some funds contributed to disruptions in the U.S. Treasury, corporate debt, and municipal debt markets." It adds that the working group "seeks to evaluate these risks and their impact on the broader financial system, and to consider additional policy options that could further mitigate such risks following the SEC's adoption of liquidity rules in 2016."

The report states that a second vulnerability relates to the use of leverage by investment funds. It discusses FSOC's re-establishment of its Hedge Fund Working Group, which will establish a risk monitoring framework across relevant member agencies. The working group also will review, among other things, "the experience of hedge funds at the onset of the pandemic and the ways in which these funds contributed to Treasury market volatility, including their liquidation of Treasury securities and Treasury derivatives."

The report explains that the Council will review the working groups' findings as they are developed. As in 2020, the Council's report expresses support for initiatives by the SEC and other agencies to address risks in investment funds, as well as data collection and analytical work aimed at the identification of potential emerging risks. It observes that the SEC has established additional reporting requirements for investment funds, with the result being that "there is now significantly more data available to regulators to monitor and analyze developments concerning fund liquidity, leverage, and risk-taking." The report recommends that "the SEC and other relevant regulators consider whether there are additional steps that should be taken to address these vulnerabilities."

Short-Term Wholesale Funding Markets

As in 2020, the report states that developments in short-term wholesale funding markets "can have implications for financial stability, as well as for the implementation of monetary policy." It discusses how certain types of MMFs can amplify stress in those markets and states that heavy redemptions in 2008 and 2020 "led to … extraordinary policy responses." The report also comments on developments in the repo markets.

The report comments favorably on the steps already taken by the President's Working Group on Financial Markets and the Securities and Exchange Commission to consider potential reforms to MMFs. It expresses the intention of the Council to monitor developments and further states that potential reforms "will be considered in the broader context of efforts by financial regulators to strengthen short-term funding markets and support orderly market functioning, including during periods of heightened market stress."

Nonfinancial Business: Corporate Credit

The report explains that the potential risk to financial stability from nonfinancial business borrowing depends on the ability of businesses to service their obligations, the ability of the financial sector to absorb losses from defaults and downgrades, and the continued willingness of market participants to provide intermediation during times of stress." It calls on regulators and market participants to "continue to monitor and analyze the exposures, loss-absorbing capacity, and incentives of different types of stakeholders" including, among other things, "the potential amplification of liquidation pressures in fixed income markets by open-end mutual funds if a significant episode of stress were to develop." The report further states that regulators and market participants should "continue to assess ways in which leveraged nonfinancial corporate borrowers and elevated asset prices may amplify stresses in the broader market in the event of a rapid repricing of risk or a slowdown in economic activity."

Alternative Reference Rates

As in 2020, this year's report identifies LIBOR transition as a potential vulnerability for financial markets and operations. The report notes that, after years of planning and preparation, the end dates for LIBOR have been set. Market participants should act with urgency to address their existing LIBOR exposures and transition to robust and sustainable alternative rates.

The report identifies several risks associated with LIBOR transition, including:

- The selection of new reference rates to replace LIBOR. The report recommends that market participants consider using SOFR and conduct an evaluation of the market depth and design of any non-SOFR alternative reference rates.

- The continued issuance of LIBOR-referencing instruments. The report notes that prudential regulators have issued guidance for their regulated entities to cease entering into new LIBOR contracts as soon as possible and no later than year end.

- The existence of "tough legacy" contracts that continue to refer to LIBOR as that rate is discontinued. The report suggests that regulators should determine whether regulatory relief would be necessary to encourage market participants to address this risk. It also suggests that regulators continue to use their authority to understand regulated entities' plans to address legacy exposures. With respect to legislative solutions to resolve legacy contracts, the report notes "it is unclear how effective [state] laws will be in fully addressing the transition for contracts ... and legal issues may remain for contracts governed by the laws of other jurisdictions."

A call-out box in the report discusses the progress that has been made in the transition over the past year, including in setting the cessation dates for LIBOR currencies and tenors, increasing market utilization of alternative reference rates for many products, and issuing accounting guidance.

Financial Market Structure

The report notes that FSOC and its member agencies "are closely monitoring how changes in market structure have affected the robustness and efficiency of capital markets and the stability of the financial system." Among the changes discussed in the report are interlinkages among dollar funding markets, developments that are putting pressure on dealer intermediation, the significant role of non-traditional market participants (e.g., principal trading firms), disruptive market events (e.g., stress in the Treasury market in February 2021), and consideration of central clearing in the US Treasury market.

The report states: "The Council recommends that member agencies continue to review market structure issues that may contribute to market volatility in key markets, including short-term funding, Treasuries, MBS, and corporate bond markets, and study the interlinkages between them. Market participants should also regularly assess how market developments affect the risk profile of their institutions. The Council recommends that financial regulators continue to monitor and evaluate ongoing changes that might have adverse effects on markets, including on market integrity and liquidity."

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endnotes

[1] Financial Stability Oversight Council, 2021 Annual Report, available here.

[2] Section 112 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 112 further requires the report to make recommendations to enhance the integrity, efficiency, competitiveness, and stability of US financial markets, to promote market discipline, and to maintain investor confidence.

[3] In addition to the recommendations summarized below, the report makes recommendations relating to climate-related financial risk; the markets for residential and commercial real estate; large bank holding companies; central counterparties; cybersecurity; data gaps and challenges; financial innovation, including digital assets such as stablecoins; and the use of technology in financial services.

[4] For more information on the Council's views and recommendations regarding climate change, see ICI Memorandum No. 33872, dated Oct. 28, 2021 (summarizing FSOC report on climate-related financial risk).

[5] A readout from the meeting is available here.

[6] See Report at 95-104.