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Federal Reserve Board Issues 2022 Financial Stability Report

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TO: ICI Members SUBJECTS: Financial Stability
Money Market Funds RE: Federal Reserve Board Issues 2022 Financial Stability Report

Recently, the Board of Governors of the Federal Reserve System ("FRB") issued their annual Financial Stability Report.[1] The report presents the FRB's assessment of the resilience of the US financial system. This memorandum briefly describes the contents of the report and highlights the discussions that may be of interest to the regulated fund industry, including the FRB's views on potential vulnerabilities in money market funds (MMFs) and open-end funds (OEFs) that invest in bonds, the Treasury market, corporate valuations, and digital currencies and stablecoins.

Content of the Financial Stability Report

- Monitoring framework: The report opens with a discussion of the FRB's monitoring framework and its distinction between sudden shocks to the financial system and vulnerabilities that build up over time. Regarding the latter, the framework focuses on elevated valuation pressures, borrowing by businesses and households, leverage within the financial sector, and funding risks, including investor runs.
- Overview: The report notes that the financial markets have experienced high volatility and some strains on market liquidity. Since the previous November 2021 report, uncertainty about the economic outlook has increased due to the Russian invasion of Ukraine, pressure on inflation, and pandemic uncertainty. Financial markets have been volatile with increases in Treasury yields and decreases in equity prices. The report states, however, that "broad funding markets proved resilient, and spillovers have been limited."
- Chapter 1: Asset Valuations: The report focuses on the increased uncertainty about the economic outlook due to continued coronavirus issues, the invasion of Ukraine, and inflation. As discussed in more detail below, the FRB states that Treasury yields increased markedly and corporate bond spreads widened considerably. The chapter includes two call-out boxes: one discussing strains in liquidity across markets including US Treasuries, equity index futures, and oil futures, and one discussing LIBOR transition.
- Chapter 2: Borrowing by Businesses and Households: The report notes that key

indicators of vulnerabilities arising from business and household debt are at moderate levels. In particular, the debt-to-GDP ratio and gross leverage largely returned to near or below pre-pandemic levels. The FRB is monitoring inflation, increasing borrowing costs, and geopolitical tensions.
- Chapter 3: Leverage in the Financial Sector: The report notes that leverage remained low at banks and broker-dealers but high at life insurance companies and hedge funds. The FRB also notes that issuance of non-agency securities, such as CLOs and CMBSs, has elevated, driven by investor demand. Further, bank lending to non-bank financial intermediaries (NBFIs) continued to increase, including lending to OEFs, among other entities. The FRB stated that "because NBFIs rely primarily on their bank credit lines to meet unexpected liquidity needs, loan commitments can experience sudden, correlated drawdowns."
- Chapter 4: Funding Risks: As discussed in more detail below, the FRB states that "prime and tax-exempt MMFs as well as other cash-investment vehicles remained vulnerable to runs, and some open-end mutual funds continued to be exposed to redemption risks because of their holdings of illiquid assets." The report particularly notes the SEC's recent proposal on MMFs and states that the proposed swing pricing provision "could reduce investors' incentive to run." This chapter also discusses vulnerabilities related to stablecoins and has call-out boxes on central bank digital currency (CBDC) and financial stability and commodity market stresses following Russia's invasion of Ukraine.
- Chapter 5: Near-Term Risks to the Financial System: The FRB identifies the following risks:
    - Russia's ongoing war in Ukraine could affect US financial stability through impact on commodity prices, higher inflation, and interest rates.
    - Elevated and persistent inflation combined with a sharp rise in rates could pose risks to the economy and the financial system.
    - Stresses in China, including in the real estate sector, could spill over to the US.
    - Inflationary pressures and adverse external shocks could lead to stresses in emerging markets that could affect the US.

In addition, this Chapter includes two call-out boxes on "Stresses in China's Real Estate Sector" and "Survey of Salient Risk to Financial Stability." The discussion in the latter box indicates that the FRB's survey of a "wide range of contacts" also identified the invasion of Ukraine as a top source of risk, particularly with respect to higher energy prices and cyberattacks. The respondents also identified risks related to persistent inflation and tighter monetary policy.

Discussions of Particular Interest to Members

Money Market Funds and Open-End Bond Funds

Consistent with prior reports, the FRB focuses on risks associated with MMFs and OEFs that invest in corporate bonds.

Regarding MMFs, the report states that structural vulnerabilities remain for some funds, particularly prime and tax-exempt money market funds. The FRB notes the SEC's recent proposal on MMFs and specifically that the proposed swing pricing for MMFs, "if properly calibrated, could reduce investors' incentive to run from funds amid stress." The report notes that other cash management vehicles that invest in money market instruments are also vulnerable to runs but are less transparent than MMFs.

Regarding OEFs, the report notes that "mutual funds that invest substantially in corporate bonds, municipal bonds, and bank loans may be particularly exposed to liquidity transformation risks." The report states that the aggregate value of corporate bonds held by mutual funds "remained high by historical levels" and that US investment grade bond mutual funds experienced modest outflows beginning in December 2021.

The FRB also finds that the Ukraine invasion has not had a material impact on the broader short-term funding markets, and that domestic MMFs are not exposed to Russian or Ukrainian entities. Similarly, the report states that the number of US mutual funds with direct exposure to Russian securities was small and funds that did have such exposures continued to meet redemptions.

US Treasury Markets

The FRB indicates that yields on Treasury securities have "increased markedly and reached somewhat above their pre-pandemic levels" given elevated inflation and a tight labor market. The report cautions that further increase in yields, due to a weaker economic outlook, could put downward pressure on valuations in other markets. The report notes that "liquidity metrics, such as market depth, suggest a notable deterioration in Treasury market liquidity," and particularly notes widening spreads in the most-recently issued Treasury securities.

In a call-out box (Box 1.1), the report focuses on declining market liquidity in the Treasury, equity index futures, and oil futures markets. The report notes that recent declines have not been as extreme as in some past episodes (e.g., March 2020), but there is concern that a risk of a sudden significant decline appears higher than normal. The report provides the FRB's framework for considering the decline in liquidity, including:

- Liquidity providers that post quotes on central limit order books bear the risk that the quotes become stale and "are taken advantage of by faster traders." This risk, as well as the risk of holding inventories, heightens with volatility. Thus, the report concludes that markets tend to be less liquid during periods of higher volatility.
- Market depth has deteriorated across interdealer Treasury markets and other equity and oil markets since late 2021. The decline reflected uncertainty about the outlook for monetary policy. The report notes that bonds with shorter maturities were particularly affected.
- On the other hand, bid-ask spreads remain more stable in the most liquid Treasury and equity markets, suggesting that liquidity providers have replenished quotes sufficiently quickly.

The call-out box states that "it is difficult to predict periods of extreme market illiquidity." The report references both the August 2019 and March 2020 episodes of "low market depth," each with different experiences with heightened (or not) bid-ask spreads.

The FRB concludes that "quoted depth is currently low in Treasury, equity, and oil markets, but there have been no reports of severe market functioning problems, and the effect on trading costs for many investors has likely been limited." The report cautions, however, that "there is a higher-than-normal risk that a significant deterioration in liquidity provision could make prices even more volatile and lead to market dysfunction."

Corporate Bond Valuations

The report notes that corporate bonds have "increased their yields more than those on comparable-maturity Treasury securities." However, corporate bond spreads remained low by historical standards, suggesting that valuations continued to be high. Other indicators suggested that investor risk appetite is also high.

The report also notes that "the share of outstanding bonds with the lowest investment-grade ratings…reached its highest level in two decades, suggesting that many investment-grade bonds remain vulnerable to being downgraded…in the event of a negative economic shock."

Digital Currency and Stablecoins

The report discusses digital assets and stablecoins from a variety of perspectives.

Regarding stablecoins, the report notes that the aggregate value of the market has grown rapidly and is highly concentrated among three large issuers. The FRB states that stablecoins "face redemption risks similar to those of prime and tax-exempt MMFs," but risks are exacerbated by a lack of transparency and amplified by the use of stablecoins to meet cryptocurrency asset margin requirements.

In a call-out box (Box 4.1), the report discusses CBDCs, which are digital liabilities of a central bank that are widely available to the public. A CBDC would be the "safest digital asset available, with no associated credit or liquidity risk." However, a CBDC also could pose risks or raise questions about financial sector market structure, the stability of the financial system, and the efficacy of monetary policy. The report notes with caution that a CBDC "could serve as a close substitute for commercial bank deposits or other low-risk assets such as government MMFs or Treasury bills." Such a shift could reduce credit availability, raise credit costs, or, in times of stress, make runs on financial firms more extreme. The FRB continues to seek input from a variety of stakeholders on CBDCs.

The report notes the Biden administration's recent executive order for an interagency approach to responsible development of digital assets and its call for FSOC to issue a report on the financial stability risks and regulatory gaps posed by digital assets.

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endnotes

[1] The report is available here.