

Minutes of the November 22 2013 Financial Advisory Roundtable (FAR) Meeting

Present: FAR Members: Terry Belton, Markus Brunnermeier, Darrell Duffie, Mark Flannery, John Geanakoplos, Laurie Goodman, Gary Gorton, Darryll Hendricks, Charles Himmelberg, Andrew Kuritzkes, Stephen Ryan, David Scharfstein, Hyun Song Shin.

FRBNY staff: Tobias Adrian, Terrence Checki, Christine Cumming, Sarah Dahlgren, William Dudley, Antoine Martin, Jamie McAndrews, Meg McConnell, Sandra Krieger, Joseph Tracy.

The meeting was on the intersection of duration risk taking and financial stability. The meeting commenced with two discussions from roundtable members centered on the questions posed in the meeting agenda (agenda and slides are available online at <http://www.newyorkfed.org/aboutthefed/far.html>). Each set of remarks was followed by an open discussion. The main topics were as follows:

How much duration risk do banks take? There was general consensus among FAR members that banks were not unusually exposed to interest rate risk. While the bond market selloff during the summer led to losses in the available for sale (AFS) portfolios of the commercial banks, the impact on the capitalization of commercial banks were contained. Roundtable members pointed out that banks were hedging interest rate risk across the holding company using outright positions and derivatives, so that the investigation of AFS portfolios or Swaps books in isolation could be misleading. Given the size of the increase in yields over the summer, reported losses by banks were not out of the ordinary. Members also pointed out that many loans on the asset side of banks had floating rate, thus benefitting from a steepening of the curve. FAR members pointed to the important risk of deposit repricing, which is difficult to gauge and hedge.

To what extent are nonbank institutions exposed to interest rate risk? Several FAR members pointed out that flow into bond mutual funds since the 2008 financial crisis has been very large by historical standards. Compared to the pre-crisis trend in flows, one roundtable member estimated that \$600 billion additionally had been allocated to bond mutual funds. FAR members expressed concern that such investments might be withdrawn rapidly in a rising rate environment. In fact, members pointed out that bond fund investors had rapidly sold off during the summer. Roundtable members also mentioned other investment vehicles such as REITs and emerging market economy (EME) funds. While REITs are highly leveraged and registered losses during the summer, the magnitude of their selling was fairly contained. EME funds registered heavy losses during the summer, and were thought to be heavily exposed to US interest rate risk.

Does rate risk play a role for credit intermediation? Roundtable members pointed out that the leveraged lending market was growing rapidly, attributable to the low rate environment. However, there was general consensus among FAR members that the rapid growth of leveraged lending was not currently leading to excessive leverage growth of either borrowers or lenders. This is so as the corporate sector had very low leverage going into the crisis and is only gradually regaining some leverage. However, the level of leverage remained low when compared to previous decades. On

the lending side, much credit intermediation shifted from leveraged investment vehicles to unlevered investments, such as bond funds, which are generally less fragile. In addition, the banking sector is still in the process of increasing capital and liquidity. The rapid growth of collateralized loan obligations was not seen as a particularly worrisome development by FAR members, and was judged to be slowing somewhat.

How does rate risk relate to monetary policy? Roundtable members expressed the view that market participants' perception of monetary tightening could trigger a selloff, and theoretically threaten financial stability. However, they did not see large financial stability risks. While FAR members thought that the slope of the yield curve was fairly steep by historical standards, they did not think that further steepening could be ruled out. Members emphasized that the impact of rising rates depended very much of the economic environment. Rising rates in an improving economic environment was perceived by FAR members to be less threatening than an environment where inflationary expectations rose. Asset purchases were generally viewed as removing duration and convexity risk from the market.