Minutes of the June 19, 2015, Financial Advisory Roundtable (FAR) Meeting

Present: FAR Members: Terry Belton, Markus Brunnermeier, John Geanakoplos, Laurie Goodman, Charles Himmelberg, Andrew Kuritzkes, Deborah Lucas, Manju Puri, Stephen Ryan, Tano Santos, David Scharfstein, Antoinette Schoar.
FRBNY staff: Tobias Adrian, Thomas Baxter, Christine Cumming, Dianne Dobbeck, William Dudley, Beverly Hirtle, Lorie Logan, Antoine Martin, Jamie McAndrews, Alberto Musalem, Simon Potter, Kevin Stiroh, Michael Strine.

The meeting was on the impact of post-crisis regulations on market dynamics, lending and balance sheets. The meeting commenced with 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). The main topics were as follows:

What is the current state of credit conditions? Members presented evidence suggesting that credit conditions remain unusually tight in mortgage markets, but are getting easier in corporate credit markets. The tight conditions in mortgage markets were attributed to a combination of legal costs, the cost of put backs, generally inadequate microprudential mortgage market regulations, lack of standardization of mortgage contracts, lack of investor trust, and the political deadlock regarding the conservatorship of the GSEs. Several members argued that standardization in the credit market would be desirable, akin to the creation of an ISDA-type standardized mortgage contract.

In credit markets, members pointed out the gradual shift to bond fund intermediation creating redemption risks as fund flows tend to follow past returns, thus amplifying positive and negative shocks. One panel member argued that the tightness of covenants was a good proxy for credit standards and presented that covenant-lite loans have become more common.

One panel member argued that the Federal Reserve should calculate a credit surface, akin to a supply curve of credit, relating the cost of credit to underwriting standards as measured by FICO scores, LTVs, and other variables. Regulatory policies and monetary policy could then be analyzed, evaluated, and communicated in terms of shifts of the credit surface. Members pointed out that the identification of the credit surface as a credit supply curve presented econometric challenges, as credit conditions are generally impacted by both supply and demand. One member argued that the Federal Reserve or the Office of Financial Research should collect data from banks and loan originators that would allow the identification of the credit surface.

Has market liquidity changed? In agency MBS markets, members stated that issuance was unusually low due to the tight credit standards and more expensive mortgage intermediation, as well as a secular decline in geographical mobility since the 1980s. The low issuance was in turn compressing secondary market trading, since newly issued securities are traded more often, leading to lower volume, and lower demand for repo backed by agency MBS. Hence, some members suggested that regulation is not the major cause for lower trading volume or lower liquidity in the agency MBS market. In corporate credit markets, some members argued that market liquidity for large trades might have deteriorated, even though bid-ask spreads and other traditional measures were showing ample liquidity. Some expressed concern about the speed of trading information release in corporate bond markets, though others argued that more transparency was generally better.

More generally, members argued that market depth had become more reactive to market volatility, creating adverse feedback loops. Some expressed the view that this development might be related to the increased presence of high frequency trading firms. As a result, liquidity illusions (i.e. the superficial appearance of liquidity that can suddenly evaporate during periods of heightened volatility), might become more common, possibly changing trading dynamics.

An important analytical point raised by one of the academic members was that market liquidity was not always a good thing, as it can deteriorate incentives for due diligence or monitoring. More generally, the question was raised what the right level of market liquidity might be, and what the right benchmark is.

What are costs of regulations? One panel member pointed out that capital and liquidity regulations, together with the stress tests, made it harder for firms to calculate their cost of capital. It was countered that the challenge in calculating the cost of capital was a reflection of the complexity of the environment in which banks operate, independently of regulations. Another member argued that the supplementary leverage ratio made repo market intermediation more costly. However, several contributors argued that this might be intended. Panel members brought up several times the view that institutional arrangements were adapting to the changed regulatory environment.

What are risks going forward? Members also pointed to the impact of unconventional monetary policy as a driver of market liquidity. It was argued that unconventional monetary policy increased the prevalence of crowded trades, and distorted risk premia giving rise to selloff risks.

Another risk that was pointed out by members was the move of mortgage origination into the shadow banking system. In fact, one member presented evidence that a substantial fraction of mortgages are now serviced by non-depository institutions.