Minutes of the April 25, 2025 Financial Advisory Roundtable (FAR) Meeting

Present:

FAR Members: Andrew Morton, William English, Atif Mian, Christine Parlour, Thomas Philippon, Maureen O'Hara, Joanna Welsh, Viral Acharya

FRBNY: Chair: John Williams, Or Shachar, Stephan Luck, Tim Nash, Bev Hirtle, Matt Plosser, Nina Boyarchenko, Caren Cox, Marco Del Negro, Keshav Dogra, Jonathan McCarthy, Narahari Phatak, Thomas Eisenbach, Tomas Jankauskas, Hyeyoon Jung, Leonardo Elias.

Summary:

The Financial Advisory Roundtable ("FAR") meeting discussed the potential financial stability implications of financial markets evolution over the past decade. Participants were presented with the following questions to consider ahead of the meeting:

1. What are the risks and benefits associated with equity trading moving off traditional exchanges?
2. How does the rise of passive investment vehicles reshape market stability and risk transmission?
3. What are the financial stability implications of the growth of private credit markets?
4. To what extent do these trends reflect deeper structural shifts in market intermediation, risk-taking, and the role of traditional banks?

The meeting began with introductory remarks, followed by a reminder from the New York Fed Staff that FAR Members must adhere to and should review the Antitrust Guidelines for Members of New York Fed's Advisory and Sponsored Groups, which were included in the meeting invitation.

The meeting then included three presentations: (1) Joanna Welsh reviewed trends in equity and income markets, and discussed causes, benefits, and risks of the rise in alternative trading venues and passive investing; (2) Maureen O'Hara discussed the increasing share of private companies in the US equity market, and the increasing share of mutual funds and ETFs in the US corporate bond market, and discussed how these developments can affect overall market liquidity; (3) Viral Acharya discussed the rise in non-bank financial intermediation and laid out how commercial banks remain exposed to non-bank financial institutions via revolving credit facilities and are thus an intricate part of the rise of non-bank intermediated credit. The presentations documents are attached. These presentations were followed by an open discussion of the topics listed on the meeting agenda.

Rise in alternative trading venues

FAR members began with a discussion about the trading evolution of US equity markets, focusing on the increase in private trading venues and its implication. The growth in trading venues was attributed to investors' need to engage in specialized trades, to lower transaction fees, and increase execution speed, among other drivers. FAR members noted that alternative venues make it easier for informed traders to trade against uninformed ones, and the lack of regulatory disclosure requirements opens possibilities for unfair-trading practices, hindering price discovery. FAR members indicated that there is a need to understand the social value of having a less centralized system where the benefit of catering investor needs balances out with the decrease in centralized exchange liquidity and increased opacity.

Rise of passive investment vehicles

FAR members then discussed the rise of passive investment and how it affects financial market stability. While ETFs made it easier to invest and increased retail investor participation, they potentially pose some risks too. It was noted that given that exchange-traded funds must adhere to their mandates, they are forced to trade securities mechanically, regardless of fundamentals, potentially leading to pricing anomalies around rebalancing periods, such as end-of-quarter, when the demand for adjustments intensifies.

Growth of private markets

FAR members noted that, in the US, there is a transition from public to private firms, mainly driven by mergers, de-listings, and fewer initial public offerings. Simultaneously, venture capital and private equity markets are rising, bolstered by an increase in exit market liquidity and lower disclosure requirements for firms. Such trends might have been affected by a prolonged low interest environment following the financial crisis that incentivized investors to search for higher returns in alternative asset classes.

A shift towards private markets is also observed in terms of where investors choose to trade. The share of trades executed off-exchange has been rising especially in micro caps and ETFs. Simultaneously, possibly as a consequence of off-exchange activity, trading on exchange is becoming less liquid and less transparent. A piece of evidence supporting this is a surge in hidden orders that currently constitutes 40% of all exchange trades.

FAR members discussed the rapid growth in corporate bond market ETFs that attracted retail investors to this relatively illiquid asset class. It was mentioned that a few ETFs dominate the space, and since there is liquidity in these instruments, not only retail but also larger institutional investors predominantly use these ETFs to hedge their positions. It was pointed out that the shift towards ETFs may cause systemic issues in times of distress when high demand from investors cannot be matched due to the illiquid nature of individual corporate bonds. The lack of dealer presence can exacerbate this issue.

Private credit markets and financial stability

FAR members suggested that, as banks face tighter regulatory constraints, credit risk is often transferred away from bank balance sheets to non-bank financial intermediaries. However, even though private credit funds are well-capitalized, banks remain indirectly exposed to their credit risk exposure through the provision of credit lines. This mechanism is amplified during economic downturns, when private credit firms need to raise funds to manage both the shocks to revenues (driven by a rise in loan defaults) as well as to funding costs (following downgrades). Therefore, although private credit firms may appear to have a sufficient capital buffer under non-stressed market conditions, the solvency of the system can be potentially questionable in times of distress.

FAR members judged that there were only a few instances in the past when this liquidity channel was tested and highlighted the risks of a scenario when both funding and revenues of private credit firms are affected. Although private credit firms have access to various sources of funding, in times of stress, they disproportionately rely on banks. This is a risk to banks, as the off-balance sheet liability becomes on-balance sheet, pressuring banks to raise more capital to meet their capital requirements. Therefore, this drawdown risk can have adverse systemic implications for financial stability.