Minutes of the November 13, 2015 of the Financial Advisory Roundtable (FAR) Meeting

Present: FAR Members: Terry Belton, Darrell Duffie, John Geanakoplos, Darryll Hendricks, Andrew Lo, Deborah Lucas, Stephen Ryan, Tano Santos, David Scharfstein, Antoinette Schoar, Laurie Goodman
FRBNY: Tobias Adrian, William Dudley, Beverly Hirtle, Simon Potter, Jamie McAndrews, Margaret McConnell, Thomas Baxter

This meeting of the Financial Advisory Roundtable (FAR) featured a retrospective of topics about financial stability. How have FAR members’ experiences during the past ten years shaped what they see as the key financial stability issues in the next years to come? How have members’ views of important factors affecting financial stability changed over time? How have FAR meeting discussions affected the members’ views on these issues and on the appropriate policy responses?

Retrospective of financial stability topics: One FAR member reviewed remaining systemic vulnerabilities. The member noted the improved design for clearing and settling of tri-party repo contracts, but pointed out the continued potential for repo-related fire sales. The member argued that the lender of last resort function of the Federal Reserve is overly limited by provisions in the Dodd-Frank Act and argued that the SIFI failure resolution plans are incomplete. The member brought up the potential for pro-cyclical margins pending the new FSB standards and argued more research was needed in this area. Finally, the member claimed that the global risk network is still too opaque. The member also described his view of the tradeoffs between enhanced stability stemming from new capital requirements and activities limits on banks and the potential for decreased market efficiency and liquidity.

Another FAR member provided a reflection on different accelerants and mechanisms that contributed to the recent financial crisis and how these factors have evolved in recent years. The factors cited included the impact of “group think” and underestimation of risk, which are mitigated by supervisory action such as the CCAR stress tests and monitoring of risk buildups by the FSOC and the OFR; unfunded or leveraged risk transfers (for instance, via derivatives); the possibility that new resolution mechanisms (“solvent wind-down”) for systemically important financial firms might not work as intended, though the member argued that the introduction of the “clean holding company” concept is an important innovation; and the interaction between liquidity and credit worthiness. The member noted that while unfunded risk transfers and exposure risk in the tri-party repo market have been significantly reduced, there is potential for central counterparties (“CCPs”) to emerge as new propagation channels. The member also argued that the accounting treatment of illiquid asset sales continues to be problematic.

Other FAR members offered a range of views about important financial stability risks and challenges. Several members commented that some financial activities seem to be moving to unregulated sectors. Members highlighted the role of alternative asset managers and financial technology (“fintech”) companies doing lending, and the migration of mortgage servicing from banks to non-banks as developments that are particularly noteworthy and that merit monitoring and further study. One member argued that small firms can exert large stress on the financial system if those firms are interconnected, and so the Federal Reserve should continue to monitor the various firms that provide financial services but that operate outside the traditional banking sector.

Another panel member raised concerns ability of regulators to measure the risk in these institutions, and the extent to which the Federal Reserve could legally lend to these institutions during a financial crisis.
Some questioned the extent to which new resolution measures would be effective if there are multiple financial institution failures and how the new resolution mechanisms would work in a crisis, especially if coordination with foreign bank supervisions were required. Members also questioned whether the Federal Reserve would be able to provide adequate liquidity in a crisis by lending just to the banking sector.

Several members noted the need for additional data that would facilitate monitoring of systemic risk. One member suggested that the Federal Reserve (or some official sector body) should publish a wide variety of systemic risk measures on a frequent basis as well as work on improving the existing statistical measures of liquidity. Another member argued that since credit markets are key factors in financial stability, the Federal Reserve should focus on estimating a “credit surface,” which is akin to a credit supply curve conditional on a number of observed characteristics of loans and borrowers. Others suggested that measuring the stock of leverage in the financial system – perhaps relative to income – would be a helpful first step in developing a full-fledged understanding of credit conditions. It was also suggested that the measurement of the stock of housing debt, rather than the flow, might be a more useful measure of macro-financial stability.

The discussion also addressed accounting issues, particularly the treatment of securitizations and risk transfer and the FASB’s new approach to the allowance for loan and lease losses. It was noted that the FASB’s treatment of these issues was affected by previous accounting problems, specifically those highlighted in the failures of Enron and LTCM. Furthermore, it was argued that the FASB has worked to make rules more flexible by adopting principles-based approaches, but progress has been slow. Some expressed surprise at continued resistance to fair value accounting for banking firms and argued that bank regulators should depart from GAAP accounting standards when these do not work effectively.

Several members noted the lack of progress in housing finance reform. One member argued that the federal government’s continued guarantee of the GSEs has enhanced financial stability in the short-run by creating a low-risk environment in mortgage lending and for agency debt, but that the longer term consequences are far less clear. Another member noted that FHA lending is still extremely tight. A third member described dismay that liquidity regulations assume the existence of Agency MBS, implicitly assuming that the GSEs will continue to exist.

Members also addressed the impact of regulatory reforms on market liquidity. The view was expressed that the new leverage ratio requirements should exclude repos and cash at central banks, since including these positions has negatively affected liquidity in the market for U.S. Treasury securities. Furthermore, it was argued that there might have been too much liquidity in mortgage markets prior to the crisis, so that any reductions in liquidity in this sector should not raise excessive concerns, though a sudden contraction in housing finance would have significant ripple effects for the financial system.

Finally, one member noted that many of the best university students were no longer going into banking, but rather going to other industries or to financial entities outside of the traditional banking sector, and expressed concern about the “brain drain” from regulated firms.