Cleveland Fed Financial Stability Panel

16th November 2023

Meyrick Chapman

Hedge Analytics Ltd

1 High interest rates - effects

- Net Interest Income yoy % change is (partially) a transfer of income from Fed to commercial banks plus low deposit betas. SVB/others are the exception, not the rule. NIM has supported earnings of JPM, Citi, BoA. But slowing. https://fred.stlouisfed.org/graph/?g=1bprN
- Relative change in interest interest rates has never been historically fast (from 0-5% is of more consequence, monetarily, than from 5-10%, especially after decade of ultra-low rates). https://fred.stlouisfed.org/graph/?g=1brKy
- The HTM problem not limited to commercial banks. It appears in the Fed's balance sheet, raising questions about independence &/or willingness to engage in QE in future.
- HTM is the business model of Private Equity industry – and increasingly Private Credit.
- Relentless move towards concentration, TBTF. Repo & Treasury dealing next?
- Problem with the use of word 'panic' for bank runs. Bank runs are rational given information uncertainty about a balance sheet.
- Financial stability requires a clear understanding of changes in the monetary framework since 2007. There is little clarity of how the changes have impacted the financial system. Rises in interest rates occur on top of fundamental changes in many parts of the monetary regime.

Beyond rate rises: an unfamiliar financial architecture.

- Since the move from a shortage, corridor system to ‘ample reserves’/floor system, there is no clear notion of liquidity elasticity in the financial system. There are educated guesses, but the boundaries for variation are huge. *(see [Reserve demand, interest rate control, and quantitative tightening](#) Lopez-Salido & Vissing-Jorgensen 2023. But that is not a comprehensive description.*
    - The collapse of SVB/Signature and others seems to have led to an increased demand for reserves. BoA saw cash/reserves rise from 6.6% of Total Assets end-2022 to 11% of Total Assets end-Q1 (presumably in response to SVB). Clearly, we know less about liquidity demand than we thought we did even 12 months ago.
    - Why? Outflows seen in bank runs this Spring were materially faster and/or larger than those assumed in the Liquidity Coverage Ratio. More reserves are needed than regulators assumed. BUT reserves can only be used by banks; reserve outflow from one, means inflow into another - ONRRP is confusing original function of reserves & Fed balance sheet.
- Reserves replace loans on bank balance sheets. Is that ok?
- Recent decline in ONRRP is generally understood to have reflected a shift into T.Bills as the government rebuilt Treasury General Account. But at least part of the decline seems to have been associated with a shift to financing hedge funds in the cash/futures basis trade which the Fed (and the BIS) identify as a financial stability threat. The ’new’ framework appears to have promoted (indirectly through Fed ‘ample reserves’) funding of what is feared to be a risky arbitrage position.

Remedies

- **<u>Key aim</u>** “maintaining monetary control, micro- and macro-prudential stability in a world of structurally larger and more volatile liquidity…” Hauser
  - 3 roles of reserves: transactions settlement, precautionary, rate of return. Little understanding of how these roles interact because never had so many transactions settled by reserves, nor had reserves offer such a high rate of return. The precautionary role may be subject to ‘interference’. For instance, what happens in a major dollar shortage?
  - The role of CB liabilities (aka ‘inside money’) especially reserves. CB reserves will be needed for settlement of future innovations (such as CBDC).
  - A return to a shortage system seems unwise & unlikely. The system needs to find the lowest bound of liquidity to efficiently allocate credit creation, rather than waste balance sheet on reserves, yet still avoid sudden liquidity drought. Is that possible? Vissing-Jørgensen, 2023 “Friedman Rule for reserves: Supply reserves to the point that they are no longer scarce.”
  - Key question: are ONRRP balances a reservoir of reserves, as V-J latterly assume? They may be, but not certain.
  - The ‘ample reserves’ system promoted ‘capital markets’ credit creation, and demoted loan creation.
  - Ample reserves are also necessary to offset the capacity constraints imposed on banks/dealers with GFC reforms.
  - A reduction of reserves in the system affects securities/repo settlement, though elasticity of reserve velocity (Fedwire) appears large.
- Remedies: **<u>formalise the ad hoc framework</u>**. Create a practical understanding of why things are the way they are and what their limits are. There are moves in this direction: Hauser at BoE, ECB’s policy review. Lorie Logan’s speech last week.
- Incorporate monetary and financial velocity as well as stock in assessments of financial stability.
- Collateralized lending demotes counterparty assessment. Moreover, the focus on ONRRP has meant a significant part of the outstanding financial balances are settled every day! There is <u>room for more unsecured lending (true trust).</u>
- <u>Policy activism should be discouraged:</u> volatility is a required feature of market adaptation.

2 Impacts outside the banking sector

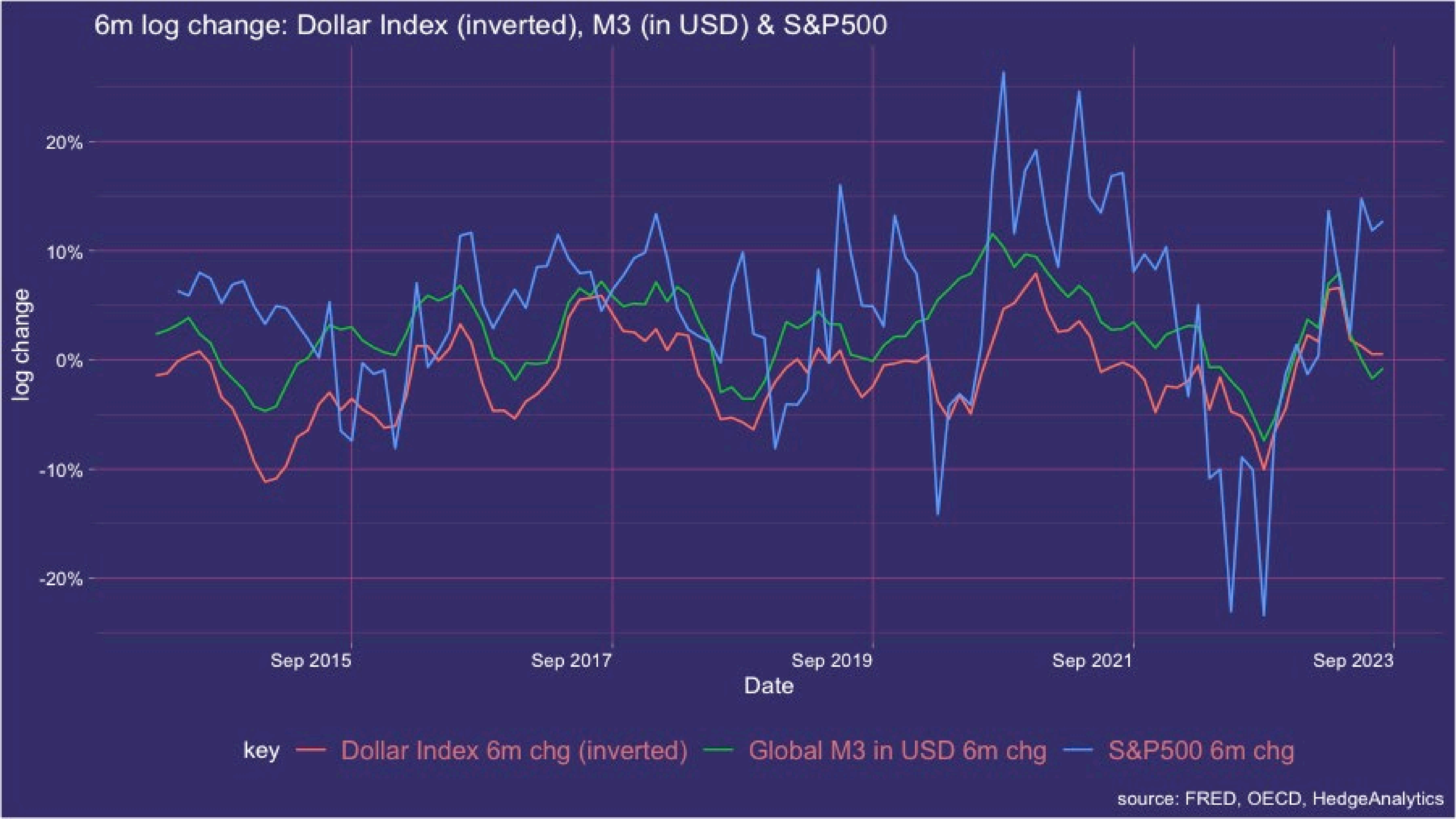
- Who bought the promise of ‘lower for longer’? Pension funds, insurance companies. Commercial Real Estate already appears to have a long-term demand problem which is now meeting a over-exuberant construction cycle from low interest rates. Yes, there will be losses. Some recent deals in San Francisco and St Louis have shown eye-watering losses.
- Private market investment $11.7 trillion AUM mid-2022. Dry powder of $3 trillion. Private equity (maybe ~$4 trillion AUM in US, $7 trillion globally) & private credit industry (~$885 bln in US) – effectively a massive HTM portfolio predicated on cheap funding forever. Deal volumes down since 2021, with market becoming more concentrated in major established names. 2022 global PE posted first negative return (-9%) since 2008.
- Private Equity Real Estate. The top 100 PERE firms have raised ~$640bln in the last 5 years.
- Apollo’s Mark Rowan: “By some estimates, dealer capital – the capital that facilitates trading – is roughly 10% today of what it was in 2008.” Yet markets are three times the size. The inventory space and volatility absorbing capacity are both tiny. BNY Mellon's Government Securities Services Corp. is the sole settlement agent for US Treasuries – cash & repo.
- Relative value trades such as cash/futures basis have attracted attention from the Fed & BIS. I think there is evidence that ONRRP build up has encouraged money-market funds to deploy repo facing hedge funds engaged in the cash/futures basis trade. This is an example of the new institutional framework working in unexpected ways. This is an example of NBFI replacing inventory function of dealers.

3 Non-bank Financial Intermediaries

- Policy-makers are endorsing expansion of NBFI. Examples: bank LCR, inclusion of MMF in ONRRP, the BoE intervention into LDI blow-up, etc,...
- Private equity has been highlighted. Private debt. Moody's: private debt may be systemic in a downturn.
- Basel rules encourage herding in banking, restricts balance sheet configuration and so encourage non-bank entrants to occupy lending roles previously offered by banks.
- Cash/basis trade as an example of non-banks entering into areas previously serviced by bank/dealers. Reforms have restricted banks/dealers capacity for offering this service. Asset managers create arbitrage opportunities which non-bank HFs exploit, not the other way around.
- If authorities want to keep control of lending/credit, then ensure that any non-bank lending remains clearly outside the scope of 'LOLR'. Losses need to be taken, even at the risk of financial disturbance.
- A guiding principle should be not to avoid financial crises, but to avoid large financial crises, which means allowing many small financial crises.

4 The international dimension

- “Recent episodes in Gilt markets, corporate bond markets, and Treasury markets underscore that episodic illiquidity in on the rise in the fixed income markets.” Maureen O’Hara, Cornell.
- Geo-political fragmentation, war. European banks with chronic profitability issues, offset by rising NIM (from ECB) – risks from changes to IOR framework. **Marginalisation of non-dollar systems.**
- The dollar’s ‘Exorbitant Privilege’ has never been so prominent. The base for stability is a/ willingness to adhere to dollar framework, b/ ability to adhere. The ability may itself be threatened by overwhelming dominance of US financial capitalism, especially in conditions of heightened geopolitical risk, US fiscal risk and pervasive ‘sanctions’.
- Staggering divergence in financial ‘weight’ US vs. RoW.
  - Since Lehman’s bankruptcy S&P 500 + 293%, SX5E + 93%
  - Assets under management: US $54tln (49.5% of total) 2022 vs $24tln in 2010 (46.5% of total), Europe $26.5tln (24%) vs. 13.9tln (30% of total) Statista data.
  - Significant European savings in US equity markets. Luxembourg total AUM EUR5 tln, total invested in US securities $2 tln. Ireland AUM EUR3.65 tln of which invested in US securities $1.4 tln.
  - Allocation of investments by public: Europe deposits(68%), US equities or funds(72%) Oliver Wyman study 2023
  - US banks RoE 12.9% cost of capital 6.7%, European banks RoE 7.22% end 2022, cost of equity 10%.
  - US price to book value 110%, European price to book value average 65%.
  - US firms dominate HF and PE AUM.
- US markets is felt in every public non-US market (commodities, equities, bonds, forex, derivative Greeks) more than ever before. This pervasiveness is long-standing but really accelerated after GFC. This raises effect of foreign financial stability on US because the RoW policy autonomy is constrained. Lessons of LTCM – US financial system found itself ‘surprisingly’ connected to RoW.
- Cyber attacks/ concentration of digital architecture (ICBC 10th November attack).


6m log change: Dollar Index (inverted), M3 (in USD) & S&P500
log change
20%
10%
0%
-10%
-20%
Sep 2015
Sep 2017
Sep 2019
Sep 2021
Sep 2023
Date
key
Dollar Index 6m chg (inverted)
Global M3 in USD 6m chg
S&P500 6m chg
source: FRED, OECD, HedgeAnalytics