Task Force on Financial Stability

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Hutchins Center on Fiscal & Monetary Policy at BROOKINGS

CHICAGO BOOTH Initiative on Global Markets

The Task Force

Co-chairs
Glenn Hubbard and Donald Kohn

Members
Laurie Goodman
Kathryn Judge
Anil Kashyap
Ralph Koijen
Blythe Masters
Sandie O’Connor
Kara Stein

Staff
David Wessel

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OUR MISSION

To identify gaps in the post-Global Financial Crisis regulatory architecture and other features of the financial system that make it insufficiently resilient to adverse developments.

To recommend ways to assure that the financial system can support growth even after the economy and the financial markets have been hit with a bad shock.

Our focus was on vulnerabilities in *markets* since banks were greatly strengthened after the GFC with implications for regulation of nonbanks.

WHAT WE DID

Identify externalities – ways in which developments in financial institutions or markets can spill over to the broader financial system and the real economy – and recommend ways to mitigate them.

WHEN WE DID IT

We began in October 2019, before the pandemic, but took account of financial market disruptions in March 2020.

Definitions

What is financial stability?

When the financial system reliably supplies credit intermediation and other vital financial services needed for the real economy to continue to grow at a sustainable rate.

Macroprudential vs. microprudential regulation?

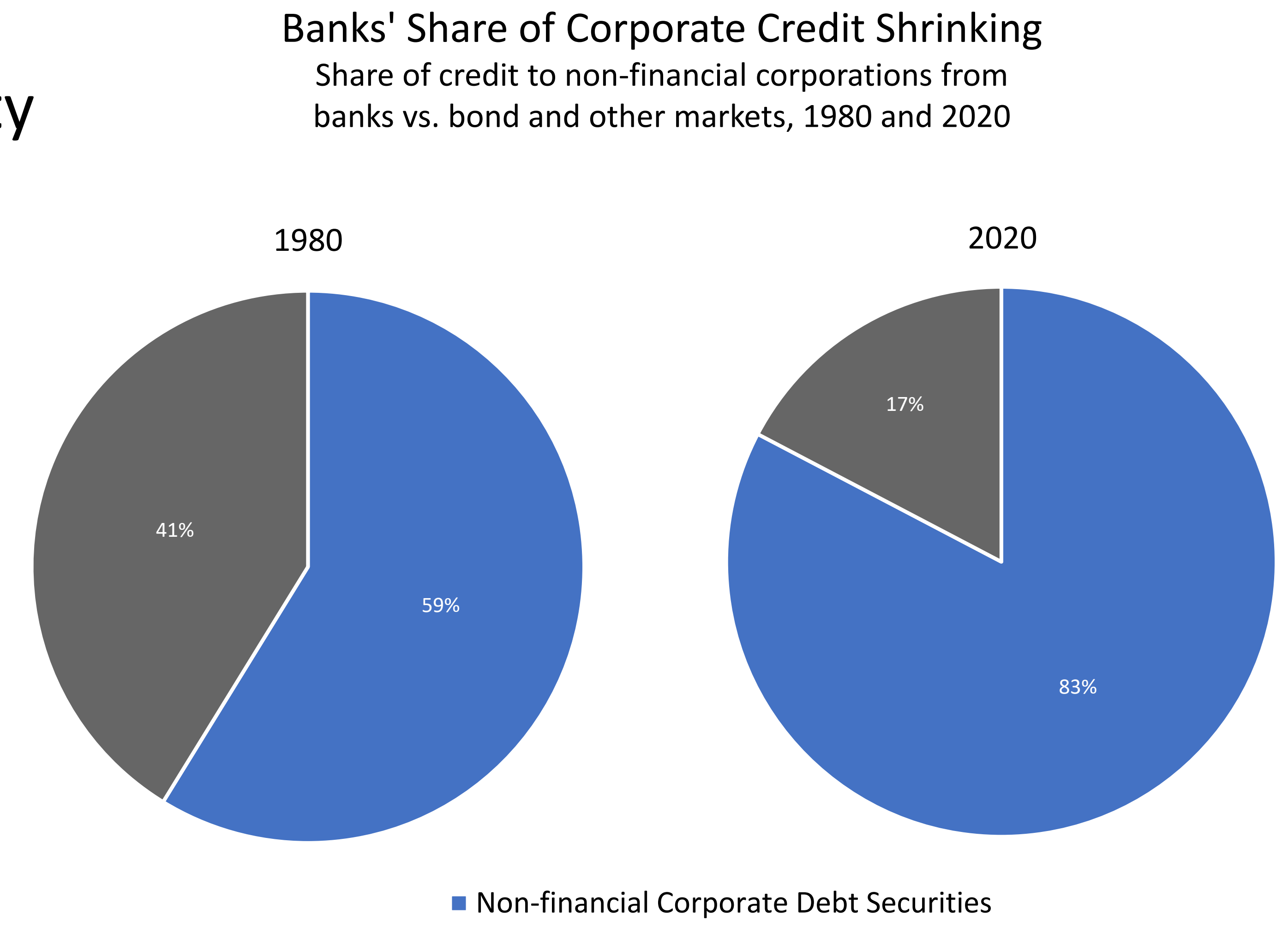
Microprudential regulation – looking at the safety and soundness of individual institutions – doesn't take account of risks to the overall financial system. Macroprudential does.

Where might instability originate?

From excessive leverage, maturity and liquidity mismatches, interconnection among institutions and markets, correlated exposures, perverse regulatory incentives, and unintended consequences.

The Task Force looked beyond banks to:

- U.S. Treasury market liquidity
- Open end mutual funds
- Housing finance
- Derivatives clearinghouses
- Insurance companies
- Regulatory structure and process

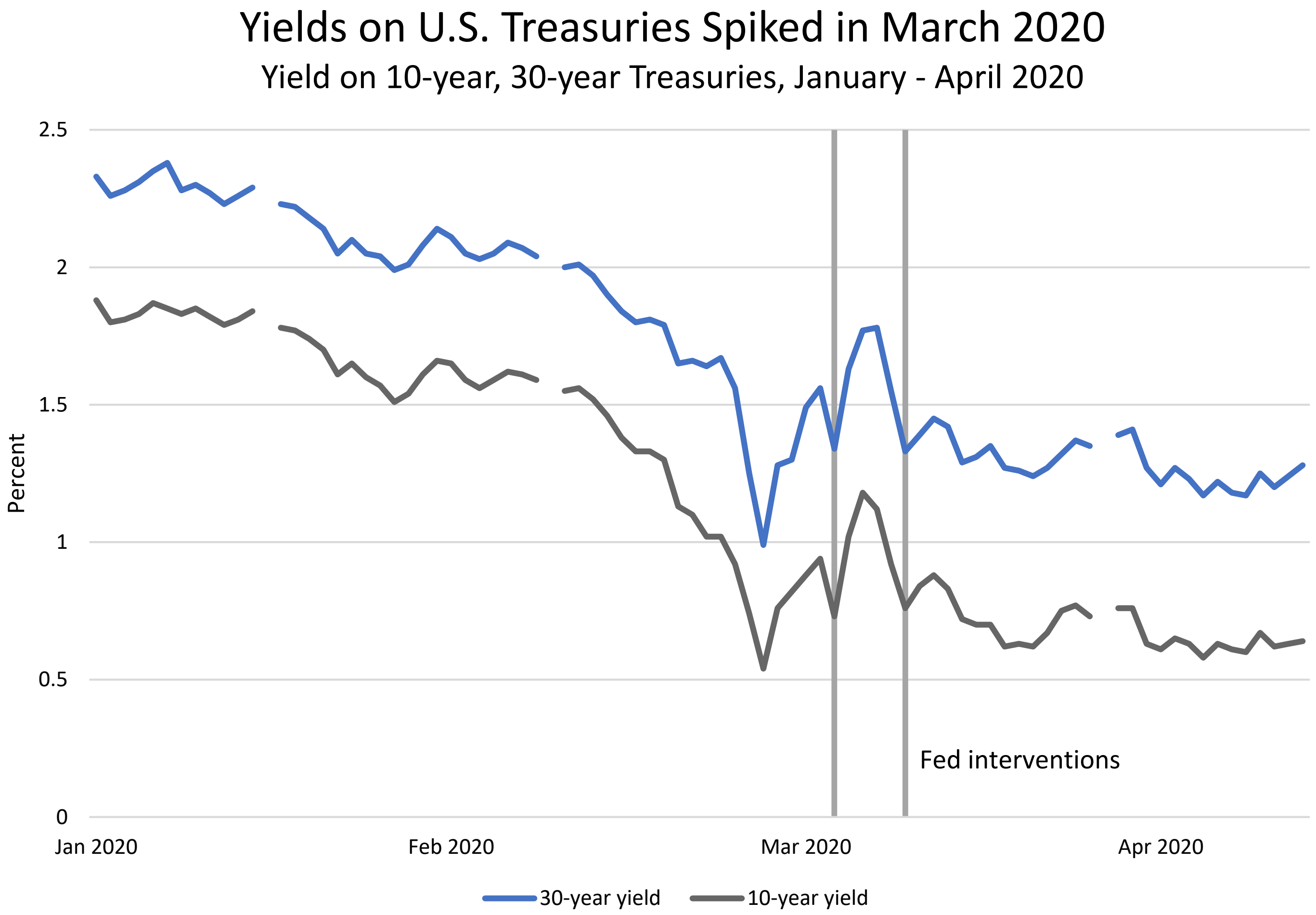


Source: Federal Reserve Board

U.S. Treasury market

Major problem:

March 2020 showed, again, that during periods of stress, the market for the world's safest and most liquid security exhibits bouts of illiquidity that lead to fire sales and threaten the flow of credit to the entire economy. Counting on the Fed to step in with huge Treasury purchases is imprudent.



Source: Federal Reserve Board

U.S. Treasury market

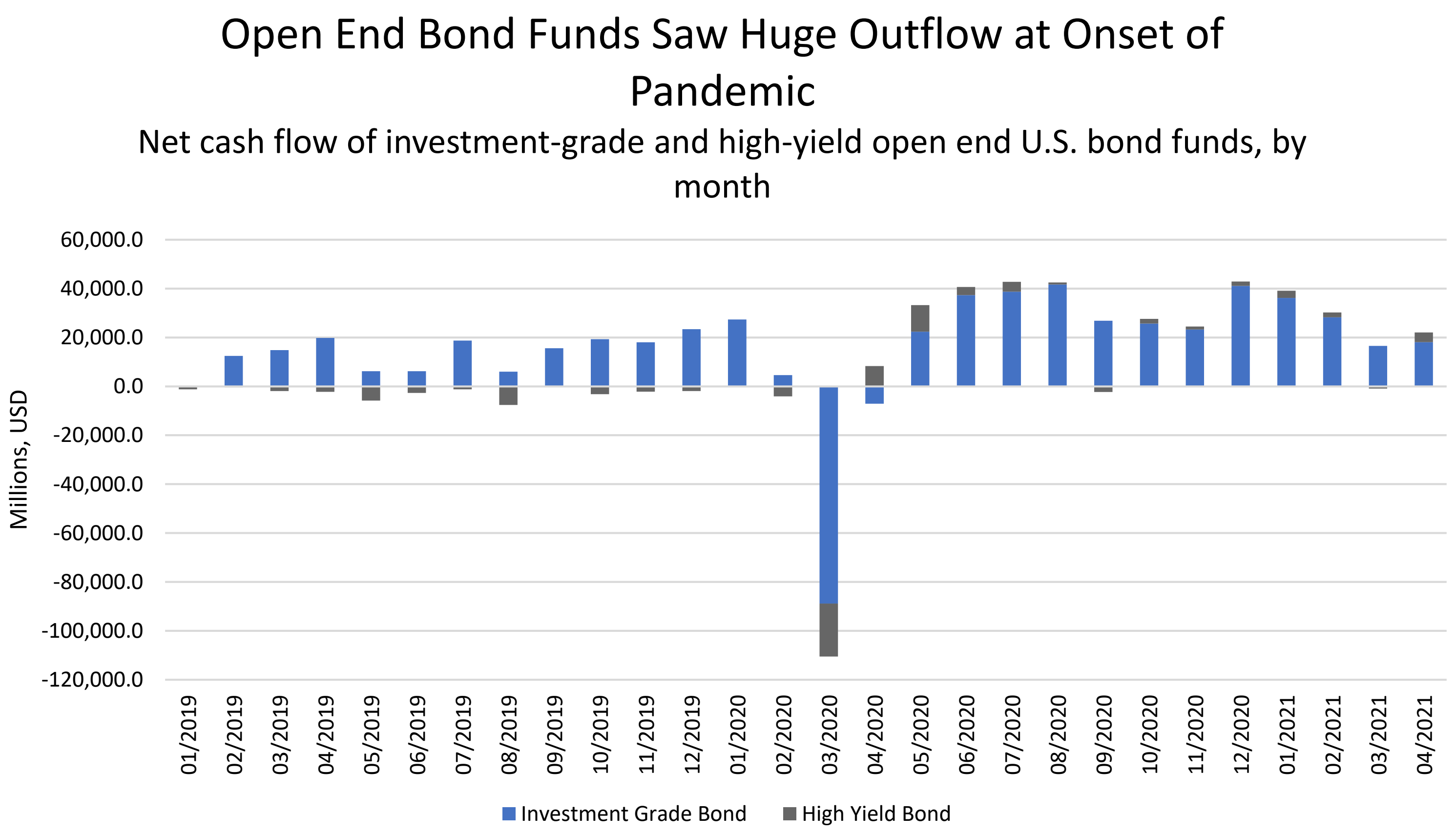
Major recommendations:

- Adjust regulatory requirements to enhance supply of market liquidity provided by banks & dealers.
- Reduce demand for liquidity at times of stress.
- Create new Fed standing repo facility.
- Consider central clearing of Treasuries and Treasury repo.

Open end mutual funds

Major problems:

- Money market and some bond funds offer investors daily redemption, but much of their portfolios are longer-term or securities that cannot be sold without significant price concessions.
- In stress, therefore, some investors may rush to be the first to withdraw funds , which can lead to large sales of Treasuries by the mutual funds and, possibly, fire sales of private assets. That, in turn, can disrupt credit markets with adverse consequences for the broader economy.



Source: ICI

Open end mutual funds

Major recommendations:

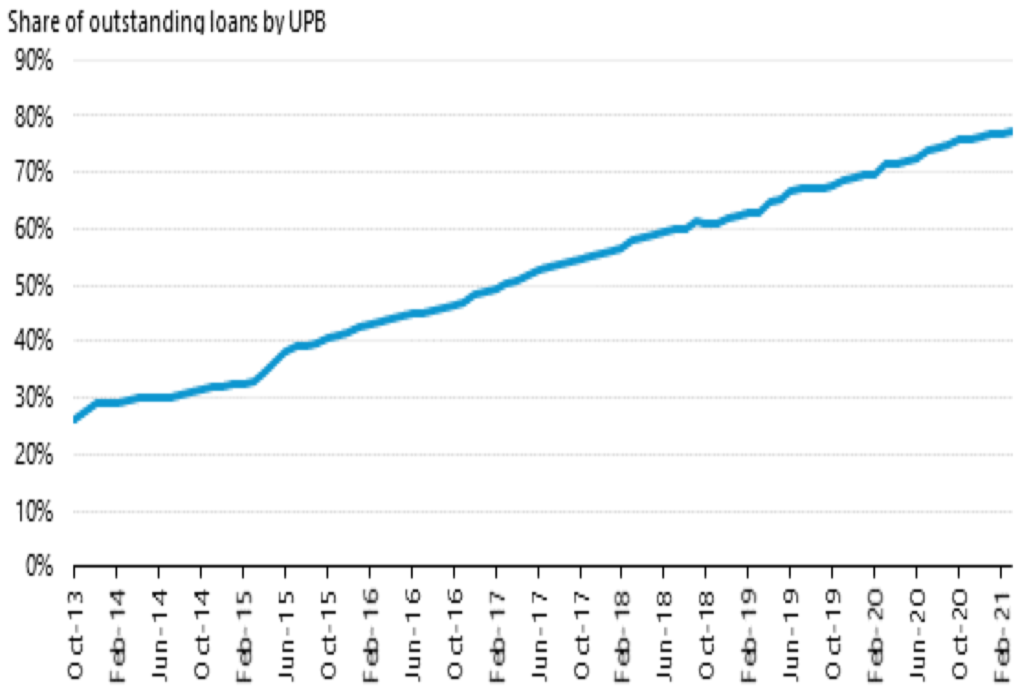
- Prime money market funds: Adopt swing pricing and/or redemption fees; eliminate connection between liquidity buffer and gates.
- Other open end funds: Require swing pricing where sensible; for others, create new category of funds with more limited liquidity and migrate some asset classes towards this structure.

Housing finance

Major problems:

- Aggregate demand spillover from over-indebted households.
- Disruption to credit supply if non-bank servicers fails.
- Spillovers to other asset classes if there is disruption in the mortgage securities market.

Share of Ginnie Mae servicing owned by non-bank servicers



Source: Urban Institute

Housing finance

Major recommendations:

- Impose residual income cap for owner-occupied properties; loan to value caps on investor properties and cash-out refinancing.
- Streamline refinancings and forbearance during national emergencies; strengthen mortgage modification toolkit.
- Create central liquidity facility for government-backed mortgage securities.
- Make FHFA prudential regulator for non-bank servicers; require it to account for systemic risk in overseeing Fannie, Freddie, FHLBs. Allow non-bank services to be FHLB members.

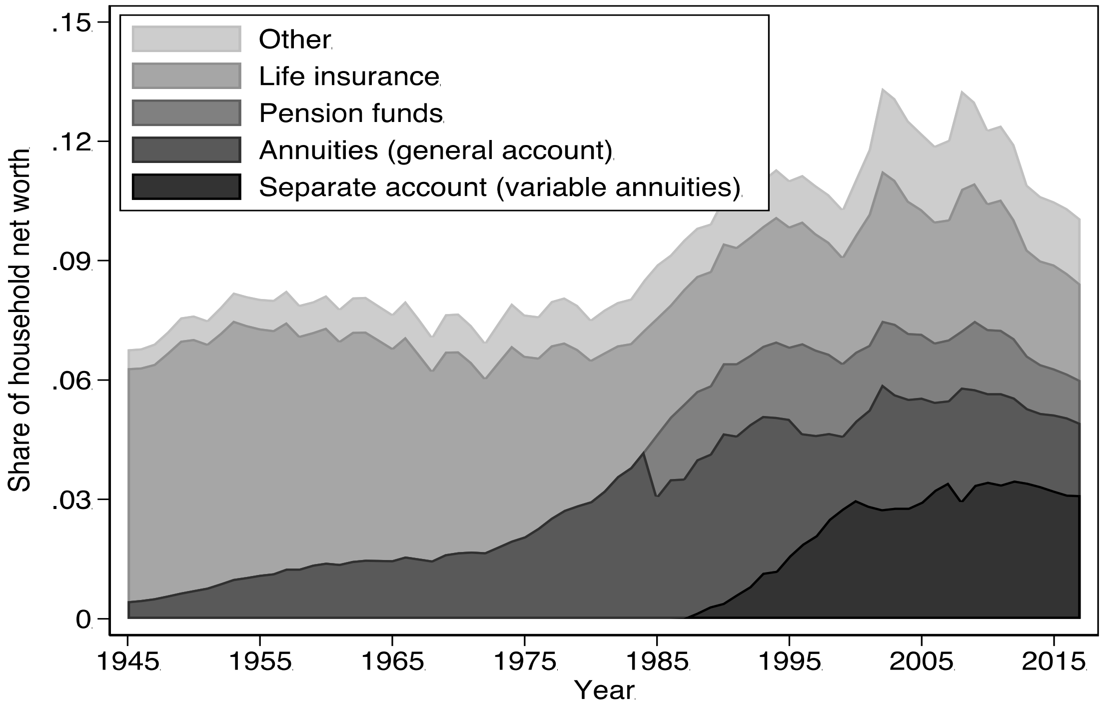
Insurance companies

Major problems:

-Growth of variable annuities with minimum-return guarantees and use of shadow re-insurance entities (with fewer capital requirements) could lead, in stress, to fire sales and reduced appetite for corporate bonds.

-Inadequate reporting hides some risks.

Variable annuities are growing share of life insurers' business



Source: Ralph Koijen

Insurance companies

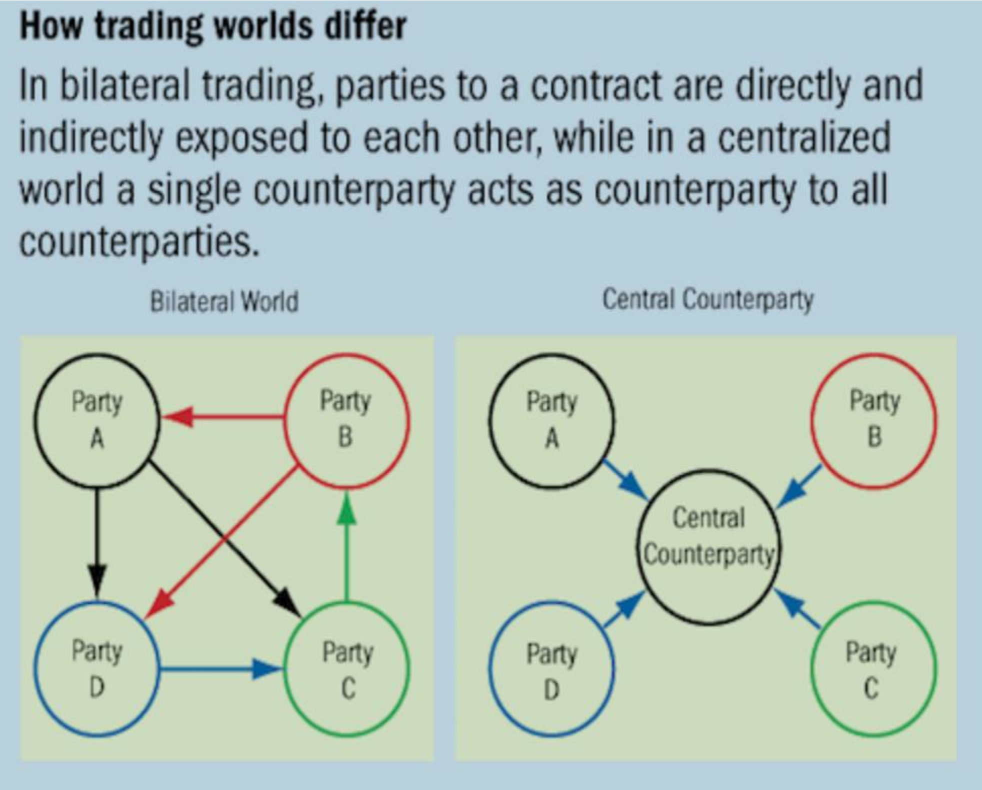
Major recommendations:

- Strengthen Federal Insurance Office.
- Mandate standardized stress tests of insurers & state guaranty funds.
- Mandate more transparency on liabilities, shadow insurance.

Clearinghouses for derivatives (CCPs)

Major problems:

CCPs concentrate operational and credit risk. Derivative CCPs are for-profit, creating misalignment of interests with clearing members. Actions CCPs may take to push losses onto members may trigger fire sales, disrupt markets, and expose end-users to unanticipated losses. Problems may spread across CCPs and borders.



Clearinghouses for derivatives (CCPs)

Major recommendations:

- Expand scope of Fed oversight of CCPs.
- Improve through-the-cycle margining and collateral practices.
- Strengthen stress testing standards, oversight and transparency.
- Align interests of CCPs and members.

Regulatory structure and process

Major problems:

- Inconsistent attention to financial stability across the members of FSOC.
- Too little accountability for identifying financial stability risks in advance and recommending action.
- Insufficiently comprehensive financial data.

Regulatory structure and process

Major recommendations:

- Give each agency explicit financial stability mandate and establish internal financial stability office.
- Focus accountability by making Secretary of Treasury the sole author of the FSOC annual report with comments from agencies and revise its format to improve usefulness.
- Create new under secretary of Treasury for financial stability with staff.
- Evolve OFR into a new Comptroller for Data and Resilience (to be voting member of FSOC).

Putting reforms into practice

- What would we have seen coming had our proposals been adopted earlier?
- Regulatory design and process reforms we propose will not guard against all possible future risks, but they would shore up the biggest weaknesses in the current system and make new holes of the same magnitude less likely.
- Even if all our recommendations are adopted, we urge periodic independent reviews of how the system is functioning given the continued evolution of the financial system. Such reviews are particularly in light of emerging risks, such as climate change and cyber.

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