Mindset

October 14, 2020

# SEC Roundtable on Interconnectedness and Risk in U.S. Credit Markets

## Opening Remarks

**SP Kothari,** Chief Economist and Director of the Division of Economic and Risk Analysis, SEC

Mr. Kothari discussed the interconnectedness of the capital markets and the real economy and asserted that the markets appear to have mostly recovered from the shock faced as a result of the COVID-19 pandemic. However, he noted that COVID-19 induced stress on various financial markets but the Federal Reserve Board (Fed), Treasury and Congress intervened in a timely fashion that reduced uncertainty and restored investors' confidence in the markets. He highlighted that the effects of COVID-19 demonstrated that market structure matters and emphasized that the long-term credit stress from COVID-19 may still be unfolding so it is important to monitor corporate debt, municipal securities and the corporate real estate market.

## Panel 1: Market Perspective
## Moderator: Sumit Rajpal, Senior Policy Advisor, SEC

PANELISTS

- **David Finkelstein**, CEO, Annaly Capital Management
- **Dawn Fitzpatrick**, Chief Investment Officer, Soros Fund Management
- **Steven Goulart**, Executive Vice President and Chief Investment Officer, MetLife, Inc.
- **Barbara Novick**, Vice Chairman, BlackRock
- **Thomas Wipf**, Vice Chairman of Institutional Securities, Morgan Stanley

The panelists began the conversation focused on the credit markets and the need for government intervention at the beginning of the COVID-19 crisis. Mr. Steven applauded the response from the federal government but raised concerns about underlying challenges to ensure better liquidity in market making and expressed the importance for banks and regulators to establish an exit strategy to allow the markets to return to their traditional role. On this same topic, the panelists agreed that despite the period of time it took for the Fed to set up some of the facilities, the markets responded as soon as the Fed and Treasury signaled a response.

Continuing the conversation, Mr. Rajpal asked the panelists if removing intermediations is the answer since at the beginning of the pandemic crisis there was significant pullback in the intermediary capacity from dealers and non-dealers. Ms. Novick explained that the circumstances were perfect for market making but banks and proprietary trading firms faced regulatory obstacles that prevented them from engaging. Given this, Ms. Novick suggested that regulators examine the market structure and the regulatory barriers that prevented banks and proprietary trading firms from intervening. Ms. Fitzpatrick and Mr. Finkelstein noted that the all-to-all platform is not a comprehensive solution to intermediation and liquidity. So much so that a material marginal buyer was absent until the Fed interjected.

While providing feedback on what they would change to avoid some of the market events this year, the panelists suggested the following: provide a counter-cyclical buffer to allow banks to provide liquidity during times of stress; expand central clearing in the Treasury repo market; implement a standing Treasury repo facility and review regulations regarding banks and money market funds.

Mr. Rajpal asked the panelists for feedback on how to improve the short-term funding system so markets are more stable during stress events. Mr. Wipf responded that moving credit risk would be invaluable. Ms. Fitzpatrick expressed support for higher initial margin and an offset where the increased margin to volatility is reduced.

On the topic of money market funds, Ms. Novick suggested decoupling the 30% test and separating it from any kind of board meeting or specific decision.

While discussing the corporate bond and leverage loan market, Mr. Wipf highlighted the shift from risk taking to risk transfer and the decline in electronic trading in March that neutralized over the subsequent three months. Ms. Novick discussed the growth of ETFs and suggested such growth is the consequence of ETFs providing transparency, liquidity and efficiency. Moreover, she noted that the volume surged during the crisis and argued that such success was due to the fact that ETFs trade on the exchange instead requiring a bank balance sheet.

Mr. Rajpal asked the panelists about issues related to the corporate credit market. Mr. Goulart highlighted the decline of credit quality over the years and explained that it was the result of growing corporate financial leverage. He noted that MetLife has been concerned with fallen angel risk and noted the wave of defaults that are expected to continue. He conveyed that default rates are high but are not reaching levels of concern. Additionally, he explained that defaults have been concentrated in the energy sector given the oil collapse that occurred prior to the pandemic. With respect to the CLO market, he stated his belief that structural protections and high investment grade tranches in the CLO market provide investors with adequate protections and noted the NAIC's strong supervision in the CLO market. To his point regarding defaults, Ms. Fitzpatrick suggested that the relative openness of corporate credit markets has helped the range of defaults that would have otherwise happened.

In response to Mr. Rajpal asking the panelists about potential systemic implications of credit risk mortgage securities, the panelists noted the small size of the market and the small chance of the market qualifying as systemic. Mr. Finkelstein argued that credit risk transfer can be made more durable and the application of balance sheet leverage should be a more conservative proposition. While discussing the increasing role of non-banks, Mr. Finkelstein explained that non-bank entities have filled the void left by banks but noted the low barriers to entry. However, he predicted a healthier sector in the long term. Ms. Fitzpatrick said non-banks play an important part in innovation and provide access but recognized that they are thinly capitalized which amplifies the cyclical access to credit.

In a discussion on mortgage REITs and how the market should be structured to become more resilient, Mr. Finkelstein suggested reducing leverage and providing more durable financing.
On the topic of commercial mortgages, Mr. Goulart highlighted the success of the commercial real estate market prior to COVID-19 and argued that the disruptions will only be short-term. Furthermore, he argued that the office sector does not offer a material long-term risk although the demand will remain slow in the near term. Mr. Finkelstein agreed and stated that the sector will likely adapt to new realities.

## Fireside Chat
## Moderator: Jay Clayton, Chairman, SEC

PANELISTS
- **Mark Carney**, COP 26 Finance Adviser and UN Special Envoy
- **Gary Cohn**, former Director of the U.S. National Economic Council
- **Glenn Hutchins**, Chairman, North Island
- **Lorie Logan**, Executive Vice President, Markets Group Federal Reserve Bank of New York

The panelists began the conversation discussing their observations of the effects of COVID-19 on the markets during the beginning of the pandemic. Mr. Carney highlighted that the traditional liquidity into the banks does not flow effectively into the non-bank sector and discussed the ineffectiveness of the bank sector as part of the solution, so innovation was necessary.

In response to Chair Clayton asking if the markets are interconnected today in different ways than in 2008, Mr. Carney agreed and explained that a lot of activities that were once performed inside of regulated banks were forced out due to regulations implemented after 2008, which led to such activity being performed in an unregulated environment.
While discussing electronic trading, Mr. Hutchins argued that increasing such trading is important. He recognized the growth in the ETF/mutual bond fund market but expressed concerns around maturity transformation and price discovery.

The panelists suggested that regulators examine the clearing infrastructure, the speed of settlement, freeing up cash and margin, and concessionary terms, and suggested that regulators memorialize their response to the pandemic to ensure preparedness for future events.

Chairman Clayton raised monetary policy initiatives applied to foreign banks and asked Ms. Logan to discuss the role of swap lines and the repo facility. Ms. Logan stressed the importance of the initiatives the Fed took with central bank swap lines and explained how the disruption in offshore markets were weighing on foreign banks. She elaborated that foreign banks became major sellers of treasuries until the Fed established new swap lines and a new repo facility.

The panelists emphasized the importance of international cooperation and Mr. Hutchins suggested that regulators invest in technology to ensure that it is aligned with trading technology.

Mr. Cohn characterized the credit market as dislocated since some have access to the capital markets and some do not and businesses without access are fighting to stay afloat. He argued that this will not lead to a great economic recovery and stated the need to create credit into all levels of our economic system which includes encouraging banks to lend within their respective communities.

On the topic of credit intermediation, Mr. Hutchins urged regulators to consider providing financing to disadvantaged communities of color. He explained that families in the Black community are not able to pass down capital because such communities lack access to capital. He suggested that this issue should be discussed in all conversations related to the economy and the capital markets.

## Panel 2: Regulatory Perspective
## Moderator: SP Kothari, Chief Economist and Director of the Division of Economic and Risk Analysis, SEC

PANELISTS
- **Tobias Adrian**, Financial Counsellor and Director, Monetary and Capital Markets Department, International Monetary Fund
- **Natasha Cazenave**, Deputy Head of the Policy and International Affairs Directorate, Autorité des Marchés Financiers (France)
- **Andreas Lehnert**, Director, Division of Financial Stability, Board of Governors of the Federal Reserve System
- **Brent McIntosh**, Under Secretary for International Affairs, U.S. Department of the Treasury

The panelists agreed that the actions taken by the Fed and Treasury at the beginning of the pandemic were effective and expressed the importance of memorializing such efforts to prepare for future events.

In response to Mr. Kothari asking about the impact of the U.S. actions outside of the U.S., the panelists discussed what foreign markets experienced, such as the selling of risk assets and how efforts like the swap lines and repo facility were effective.

The panelists discussed money market funds and Ms. Cazenave highlighted the impact on the money market funds in Europe and explained that money market liquidity froze for days in.  Mr. Lehnert noted that since the pandemic the government has provided over $1 trillion to corporations and state and local governments in order to ease financial conditions and provide access to credit to employers.

On the issue of risk taking, Mr. Adrian expressed that risk taking is necessary but should not become excessive.  He raised a market function issue that led to the treasury market becoming one-side in March and explained that usually a sell-off market signals downside risk to growth where monetary policy should ease to eliminate some of such downside risk.  Mr. McIntosh responded and noted that the response was driven by a health risk not a financial risk and argued that companies should not be expected to self-insure against systemic risk under the circumstances.

Mr. Kothari discussed the difference in losses between equity markets and credit markets and governments' responses to each.  He asked the panelists why the credit markets warrants policy interventions and if there are consequences of such repeated interventions.  The panelists explained that credit markets tend to have more leverage and more leverage positions and the markets were critical elements of the response to the pandemic.  Moreover, the panelists agreed that the intervention provided a backstop so investors would regain confidence in the markets.