Minutes of the April 16, 2018, Financial Advisory Roundtable Meeting

Present: FAR Members: Hayley Boesky, Laurie Goodman, Bradford Hu, Deborah Lucas, Lynn Paquette, Srini Ramaswamy, Stephen Ryan, Til Schuermann. Federal Reserve Bank of New York attendees: Nina Boyarchenko, William Dudley, Thomas Eisenbach, Linda Goldberg, Michael Held, Beverly Hirtle, Anna Kovner, Matthew Lieber, Antoine Martin, Susan McLaughlin, Simon Potter, Joshua Rosenberg, Joao Santos, Kevin Stiroh, Michael Strine, Angela Sun.

Summary

The evolving infrastructure of the U.S. financial system—and the implications of this evolution for systemic risks in the financial system—was the main topic of discussion at the Financial Advisory Roundtable ("FAR") meeting. The meeting included three presentations by Federal Reserve Bank of New York ("FRBNY") staff on (1) reference rates for financial instruments, (2) changes in the U.S. repo market since the crisis, and (3) changes in U.S. over-the-counter ("OTC") derivatives markets. These presentations were followed by an open discussion on the topics listed in the meeting agenda.

Reference Rates

FAR members discussed recent developments related to reference rates. Historically, financial contracts, especially derivatives contracts, have used USD LIBOR as the reference rate. In 2014, in the wake of the LIBOR fixing scandal, the Board of Governors of the Federal Reserve System ("Board") and FRBNY convened the Alternative Reference Rates Committee ("ARRC") to identify alternative USD reference rates. The Board and FRBNY reconstituted the ARRC in March 2018 to mitigate risks related to LIBOR and to support the transition to alternative reference rates, namely the new Secured Overnight Financing Rate ("SOFR").

FRBNY and the Office of Financial Research ("OFR") began publishing the SOFR in April 2018. In contrast to LIBOR, which is calculated based on a survey of banks, the SOFR is computed based on funding transactions, covering a significant portion of both underlying markets and market participant types. These design elements lead the SOFR to be closely correlated to other money market rates and to have lower exposure to the credit risk of individual institutions. FAR members noted that, although the absence of a credit component to SOFR is a marked departure from LIBOR and may be undesirable from the viewpoint of certain market participants, the construction of SOFR parallels the construction of new alternative reference rates for currencies in other jurisdictions.

FAR members also urged the ARRC to accelerate the introduction of alternatives to term LIBOR, noting that financial contracts usually reference either the three month or the six month rate, making an extension of SOFR to longer maturities necessary for its broader use.

Changes in the U.S. Repo Market

FAR members also discussed recent developments in the U.S. repo market. Members noted that, in the run-up to the financial crisis, intraday credit provision by clearing banks made the tri-party repo market risky. Regulatory reforms since the crisis, including tri-party repo infrastructure reform, Basel III capital regulation and money market fund ("MMF") reform have engendered significant changes in the U.S. repo market. FAR members discussed whether such reforms have been successful in enhancing the financial

stability of the repo market and its participants, noting that Basel III regulations make dealers less vulnerable to solvency risk, and MMF reform has incentivized higher flows into safer government funds. FAR members also noted that the timing of the reduction in volume of repo funding suggests that the supplementary leverage ratio has had an impact on the use of repo funding.

FAR members identified several sources of risk that remain in the tri-party repo market, including concentration risk and lack of competition in tri-party clearing; risk-shifting, in the form of banks facing similar regulatory constraints for exposures with different amounts of associated risk; and potential fire sale risk associated with dealer default. More broadly, FAR members noted that regulation may be discouraging innovation in markets, drawing a parallel to the deregulation of the telecommunications sector in the 1980s and 1990s, which led to increased innovation in that sector. FAR members argued that regulations' beneficial effect of reducing systemic risk should be weighed against potential costs in terms of lower growth.

Changes in U.S. OTC Derivatives Markets

FAR members also discussed changes to U.S. OTC derivatives markets since the financial crisis. Noting that the size of the OTC derivatives markets was growing rapidly prior to 2008, FAR members discussed how the OTC derivatives markets have changed in response to weaknesses in market design identified during the crisis. FAR members noted that changes of particular importance include the introduction of central clearing counterparties ("CCPs") and mandatory clearing for certain types of contracts, electronic trading, and mandatory initial margin on derivative positions. FAR members also noted that, combined with increased capital requirements for derivative positions under Basel III regulations, these changes have increased the cost of market participation for regulated institutions. FAR members also discussed potential unintended consequences of these market reforms, noting that central clearing could create more, rather than less, systemic risk if CCPs do not have access to a lender of last resort facility during a crisis.

Other Topics

While commending the work of the ARRC, FAR members noted that other areas of concern to the industry, such as cybersecurity and monitoring of crowded trades, would also benefit from official sector leadership. FAR members raised particular concerns that regulators are taking different approaches to cybersecurity. FAR members said that the Federal Reserve System should improve coordination between financial institutions and the public sector, as cybersecurity has stability implications beyond the financial sector.

Finally, FAR members discussed how banks might be responding to the Comprehensive Capital Analysis and Review ("CCAR") stress tests and other regulatory constraints by, for example, diversifying their lines of business or shifting to non-systemic business activities. Such trends may potentially create more homogeneity amongst banks, which could pose systemic risk concerns.

Administrative

Two new FAR members, Hayley Boesky and Srini Ramaswamy, were introduced at the meeting. In addition, FAR members were provided with copies of the FAR Charter ("Charter") and the Antitrust Guidelines for Members of FRBNY's Advisory and Sponsored Groups ("Guidelines") and reminded that

they are required to adhere to the Charter and the Guidelines and to review these documents at least annually.