Financial Stability Retrospective

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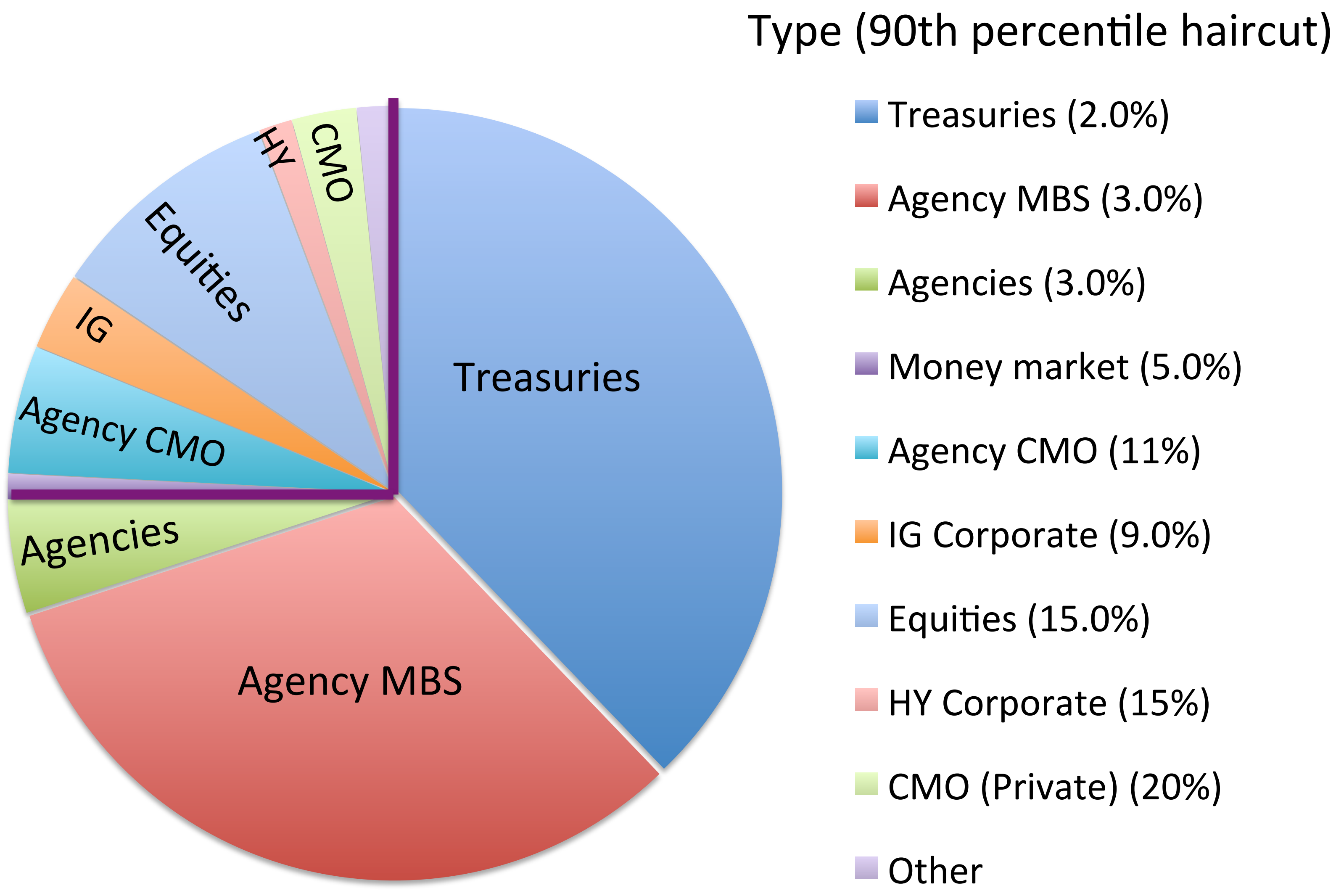
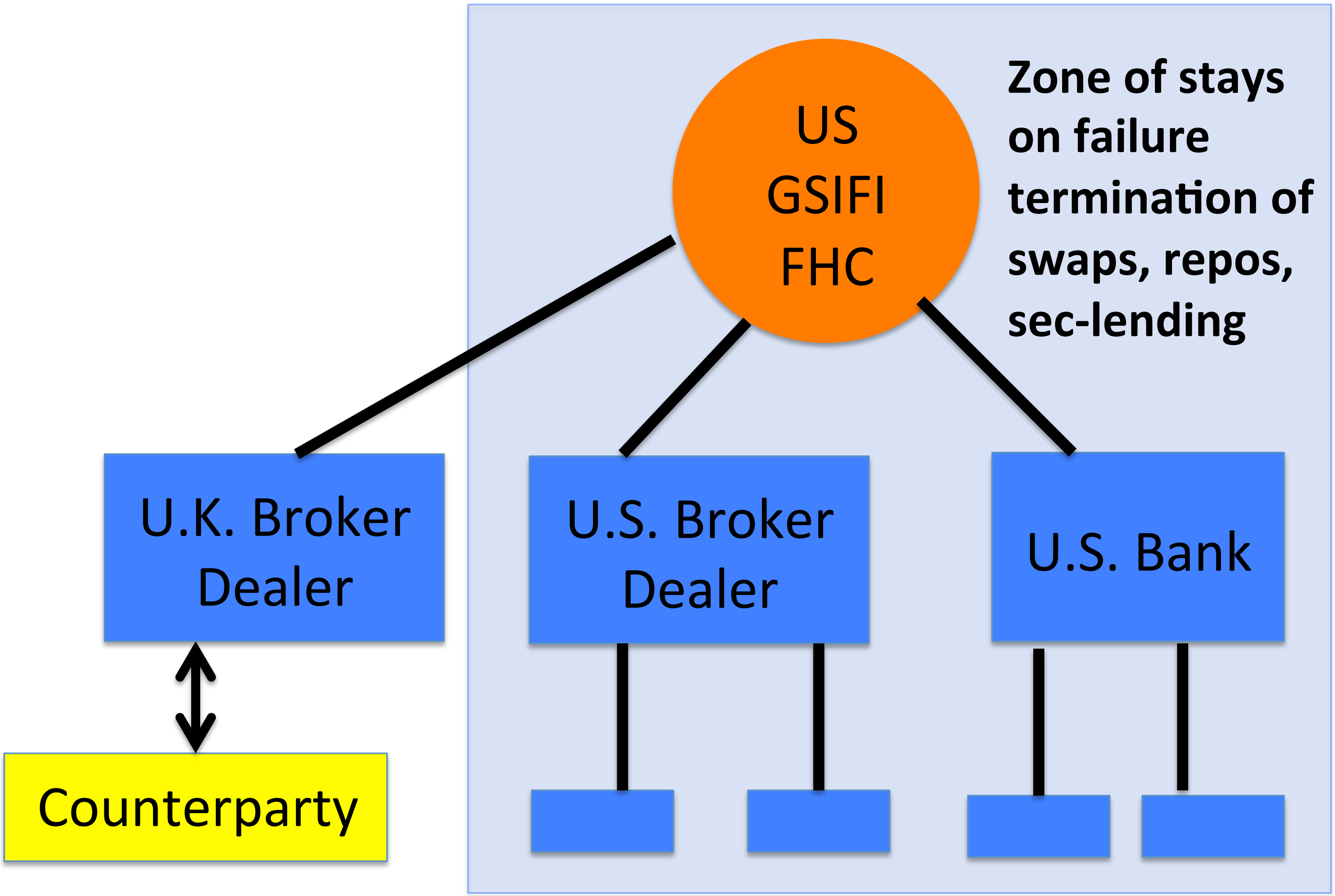
Some remaining systemic vulnerabilities

- Improving but still fragile design of tri-party repo leaves the potential for repo fire sales.
- Lending of last resort is overly limited by Dodd-Frank.
- SIFI failure resolution plans are incomplete (e.g. QFC terminations, no CCP plan).
- Potential for pro-cyclical margins, pending new FSB standards (more research needed).
- The global risk network is still too opaque.

U.S. tri-party repo collateral and liquidity



Data source: FRBNY, November, 2015
http://newyorkfed.org/data-and-statistics/data-visualization/tri-party-repo/#interactive/volume

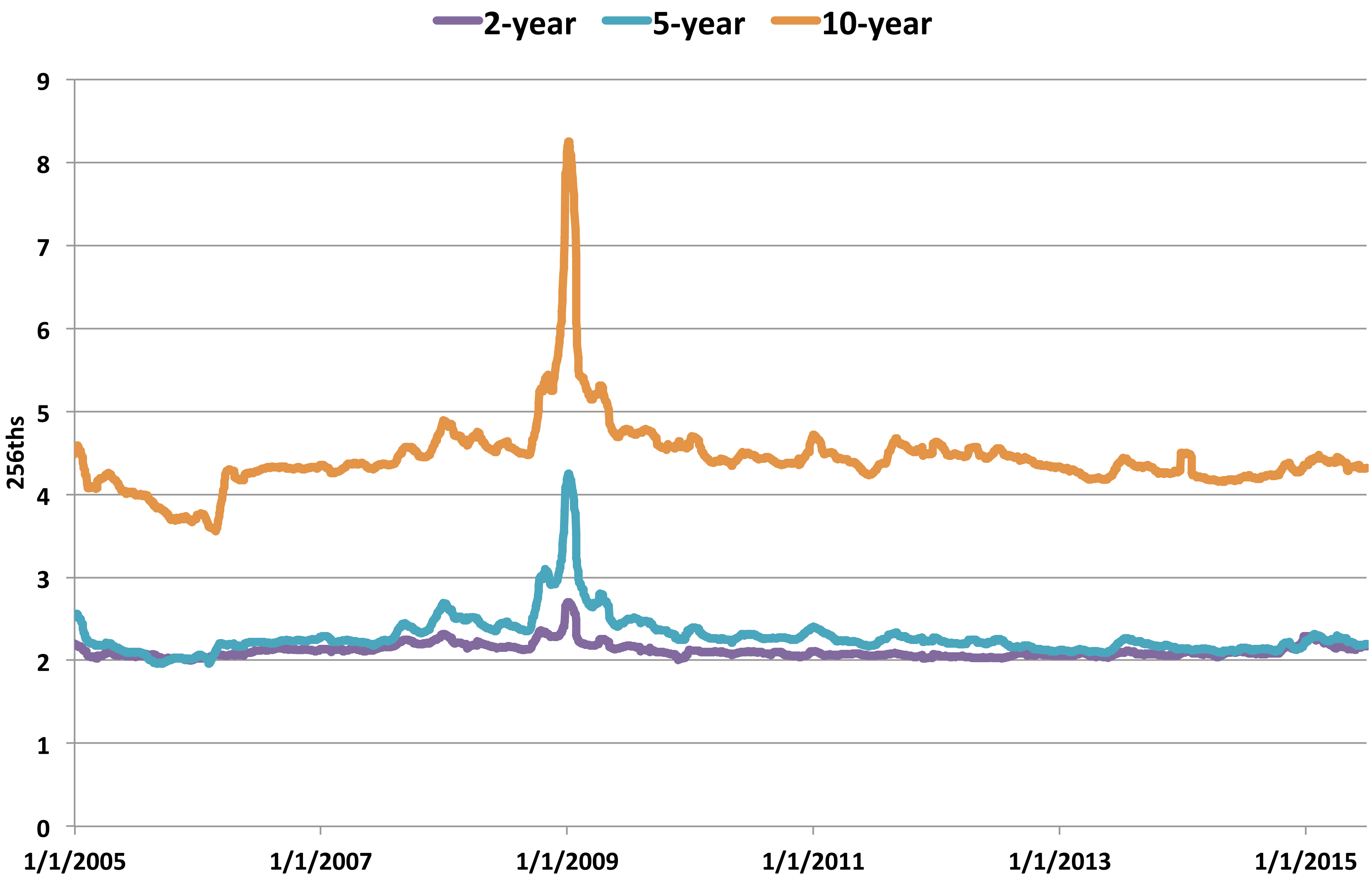


US
GSIFI
FHC
Zone of stays
on failure
termination of
swaps, repos,
sec-lending
U.K. Broker
Dealer
U.S. Broker
Dealer
U.S. Bank
Counterparty

Stability-liquidity tradeoffs

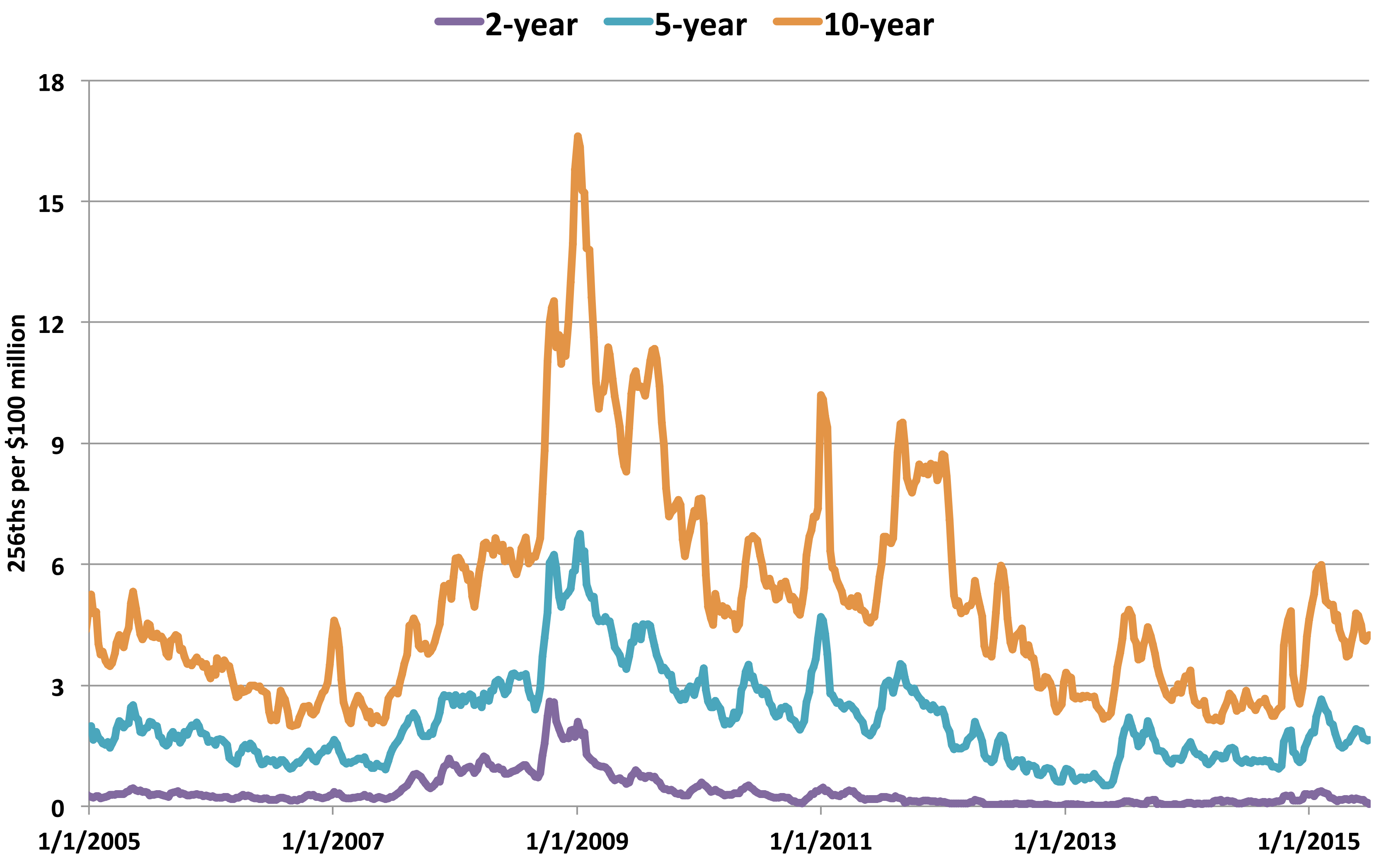
- Bank capital and activity rules have improved bank stability and reduced commitments of balance sheet to financial market intermediation by banks and their affiliates.
- This raises incentives for agency intermediation, CCPs, all-to-all trade, shadow-bank intermediation, and a shift by banks away from low-risk standardized (low-margin) products.
- The net impacts on market efficiency are still playing out.
- By most measures, bond-market liquidity looks fine, but turnover and average trade sizes are down.
- Some markets (e.g. single-name CDS, matched-book repo) are withering.
- The 10-year treasury "yield crash" of October 15, 2014 is a symptom of change in the mix of intermediaries.

Treasuries bid-ask spreads are stable



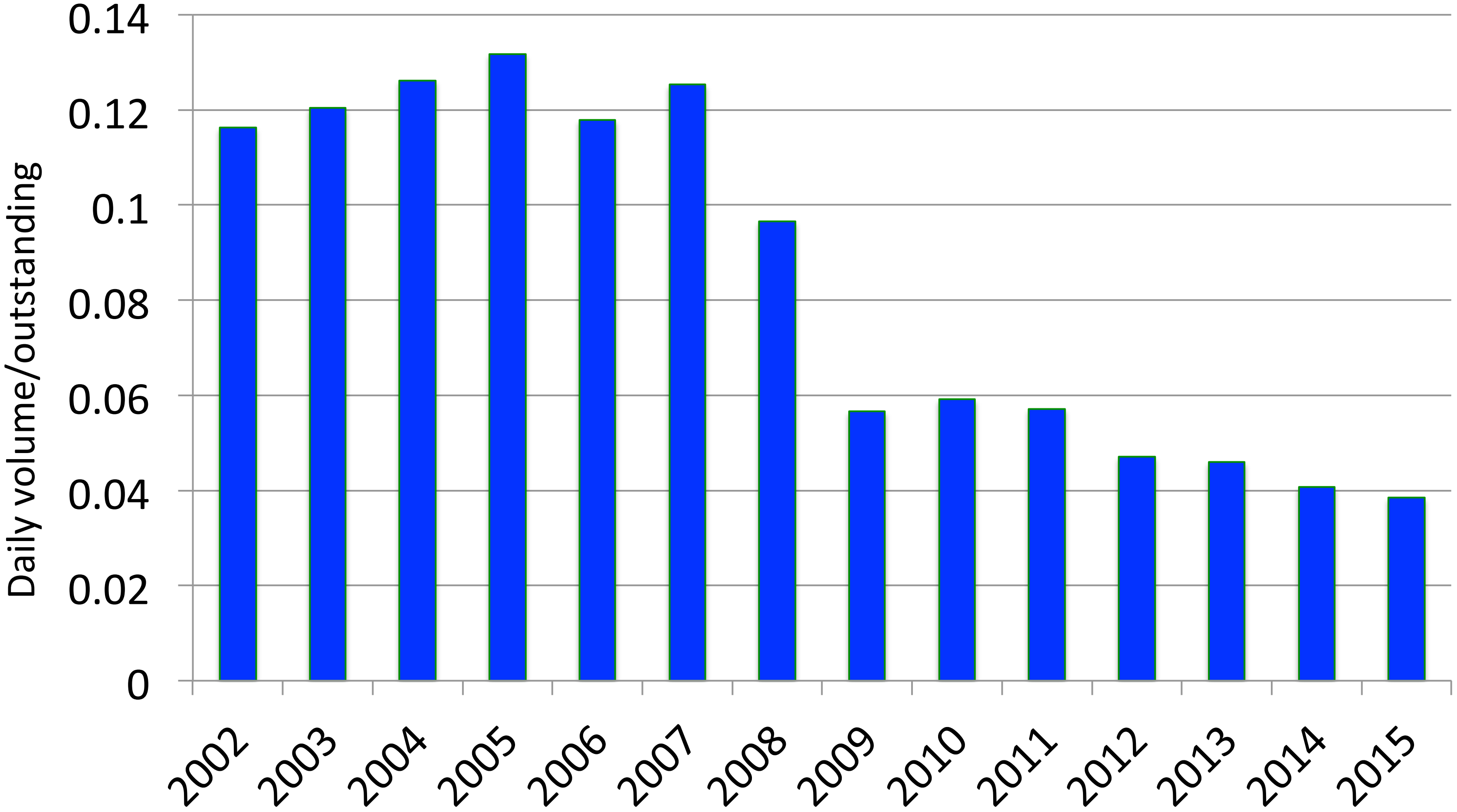
Source: Adrian, Fleming, Stackman, and Vogt (2015) (BrokerTec data)

Treasury note trade price impacts

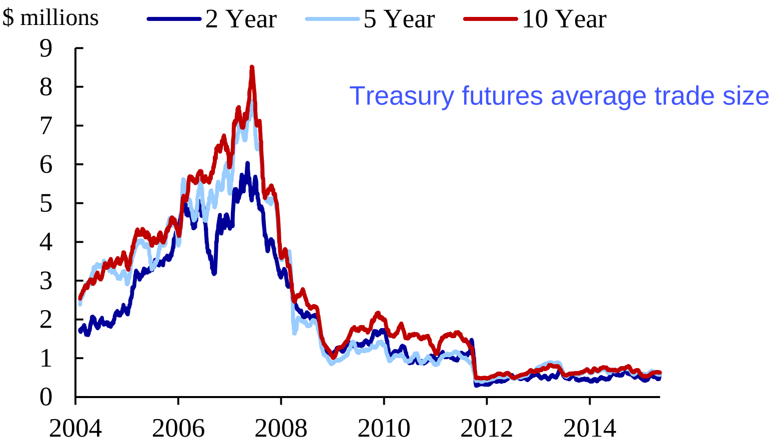


Source: Adrian, Fleming, Stackman, and Vogt (2015) (from BrokerTec data)

Treasury market turnover



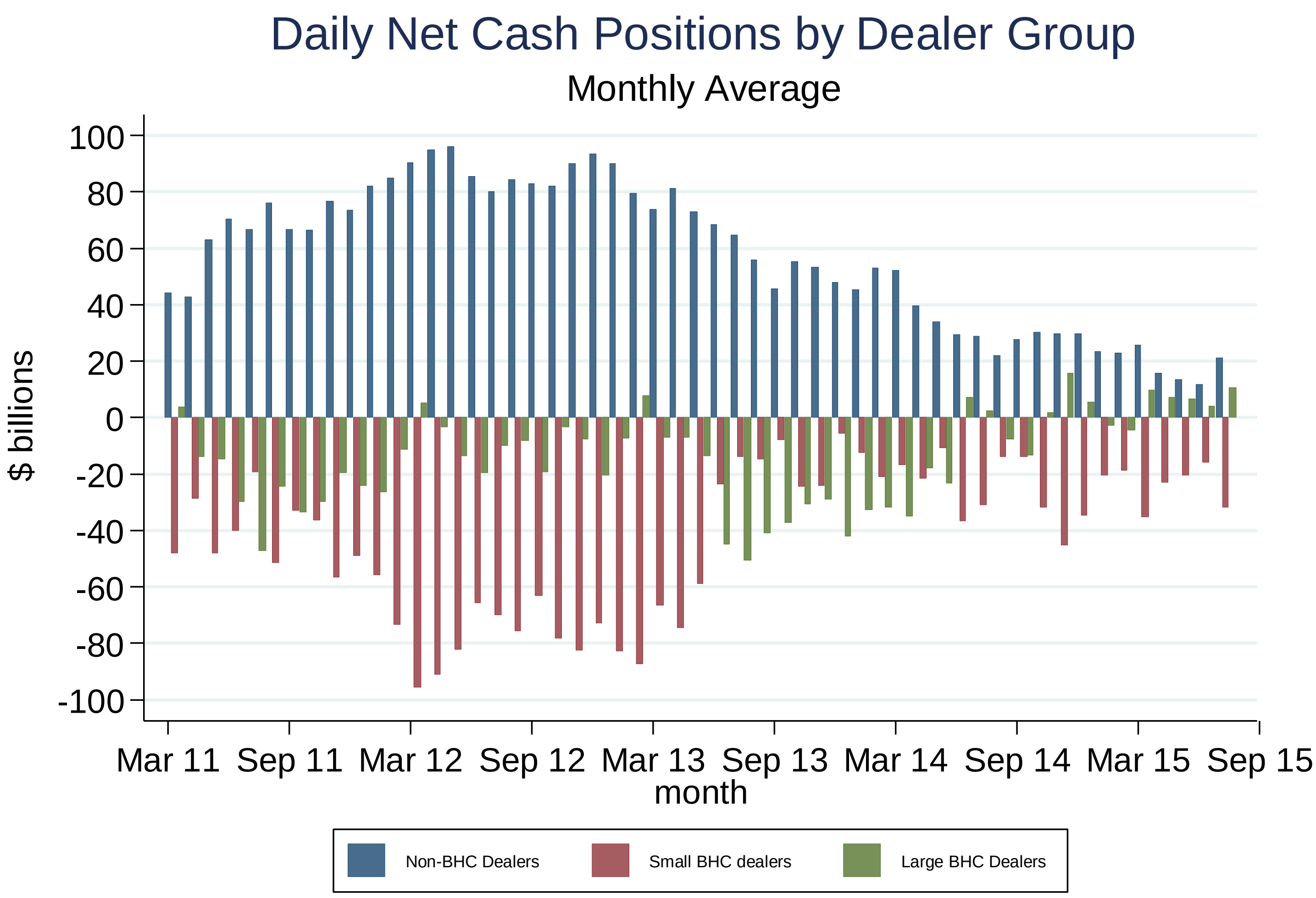
Underlying source: SIFMA



Note: 21-day moving average; 8:20 - 15:00 ET
Source: Staff calculations, based on data from CME Group.

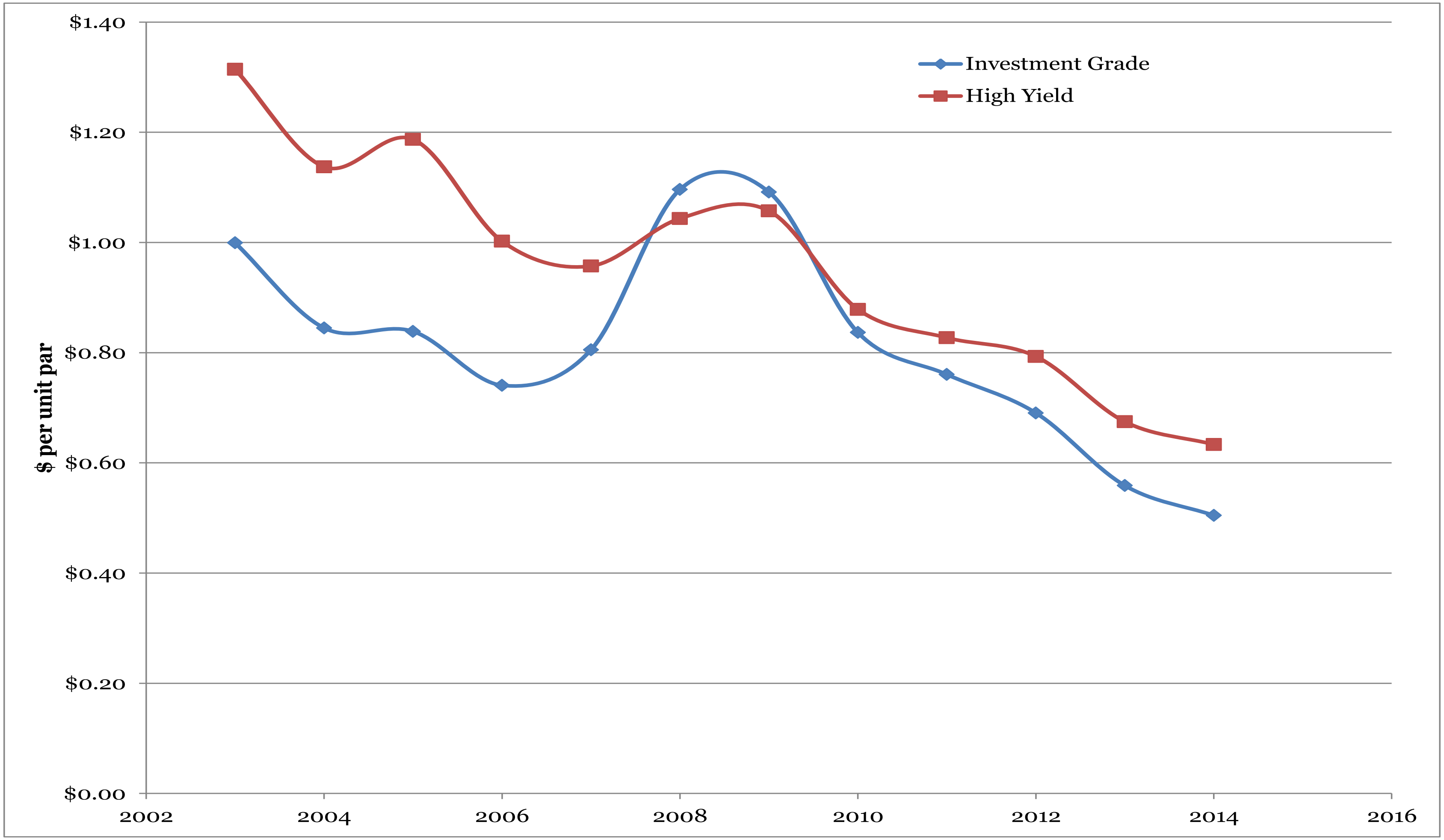
Source: Joint Staff Report, The U.S. Treasury Market (2015)

Decline in GCF net lending volume

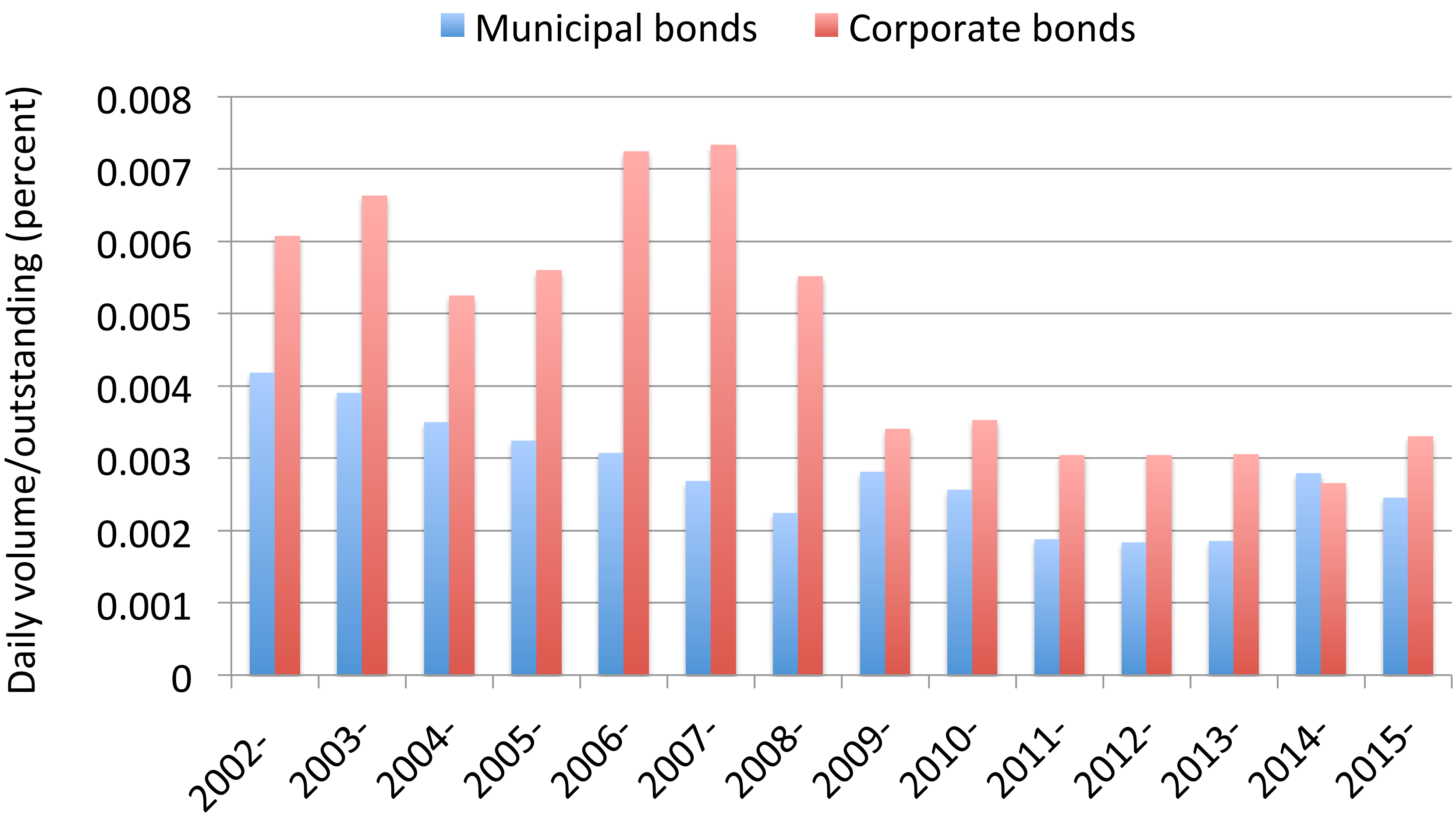


Source: Martin (2015), FRBNY.

Corporate bond – average bid-ask spreads

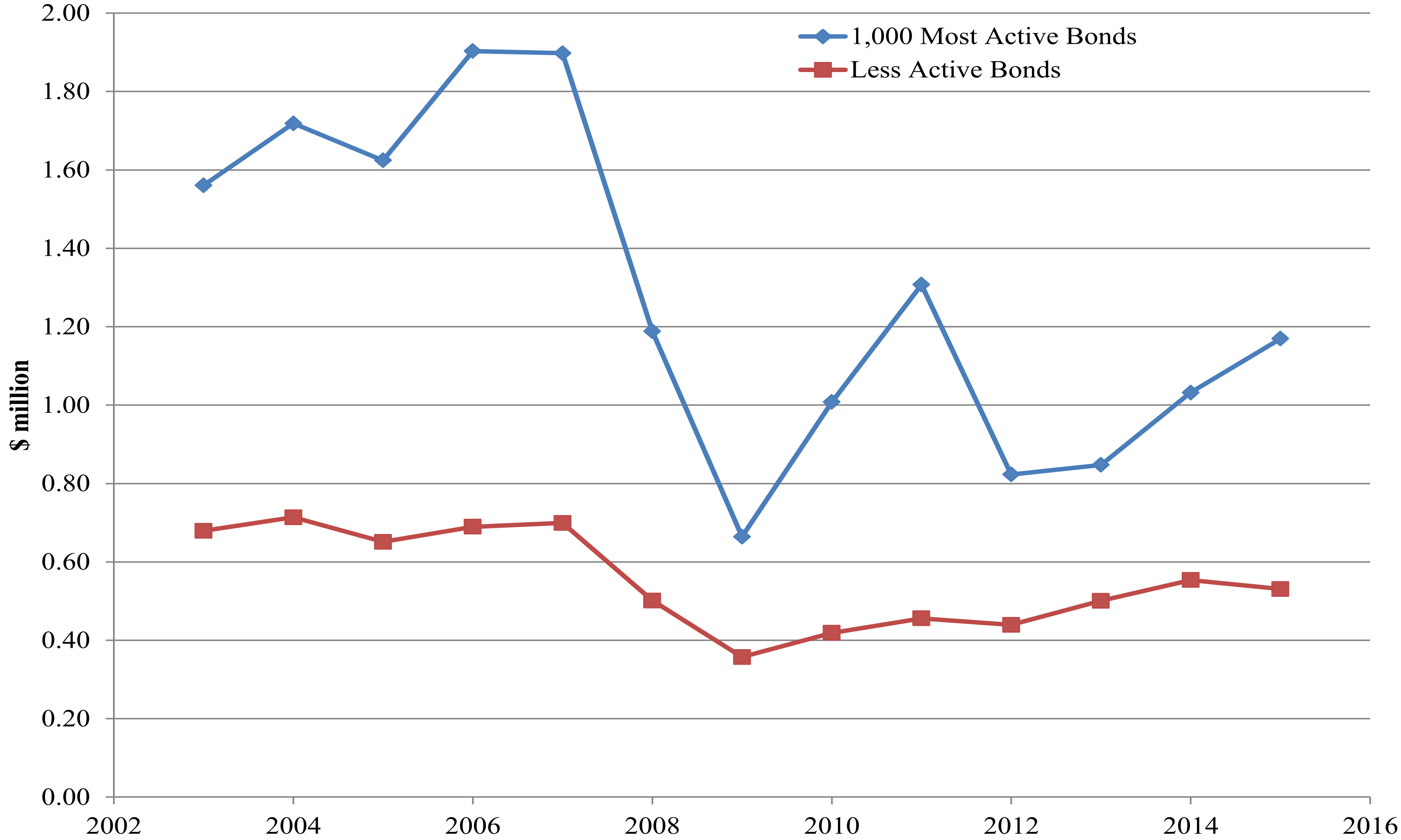


Corporate and municipal bond turnover

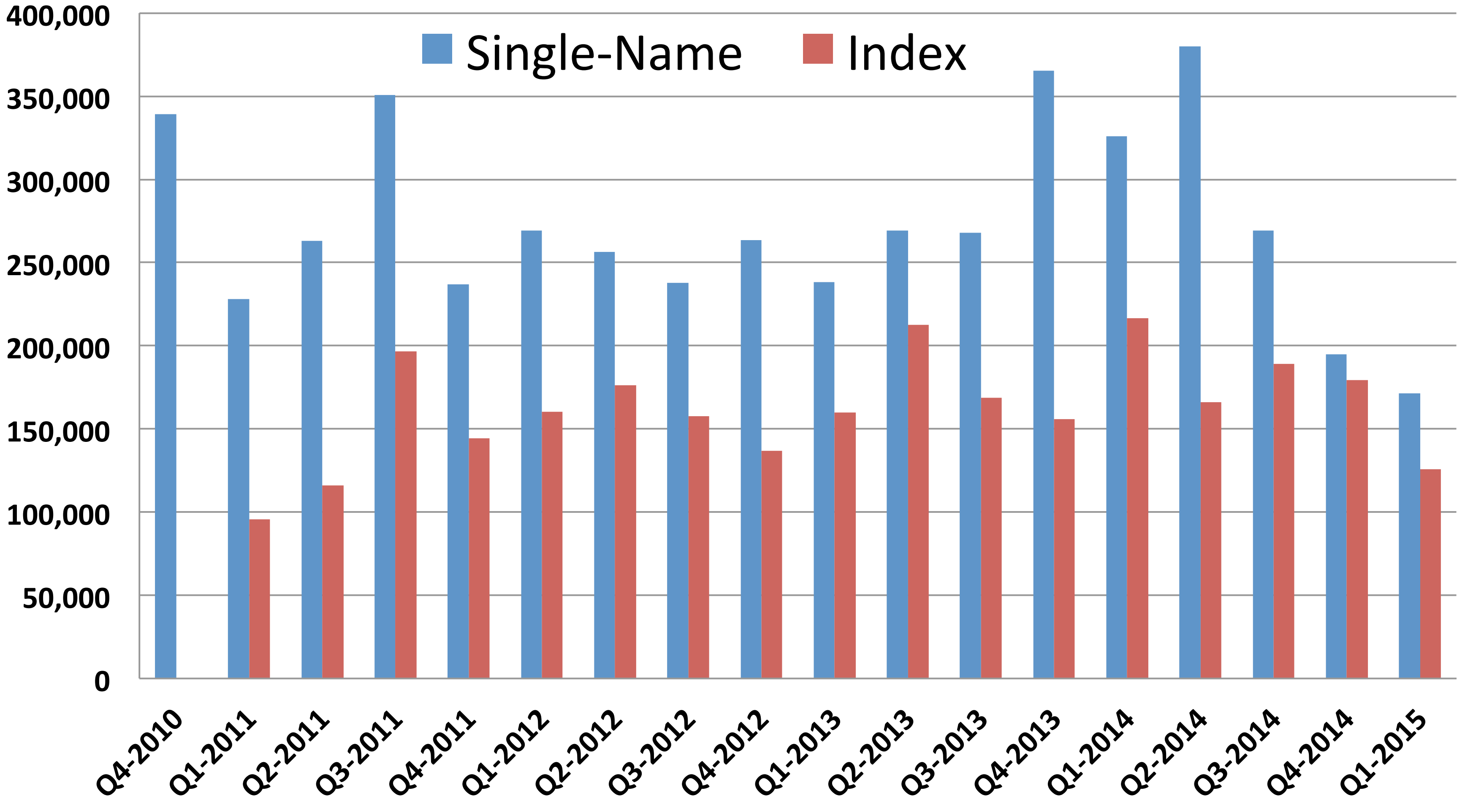


Data source: SIFMA

Corporate bond – average trade size

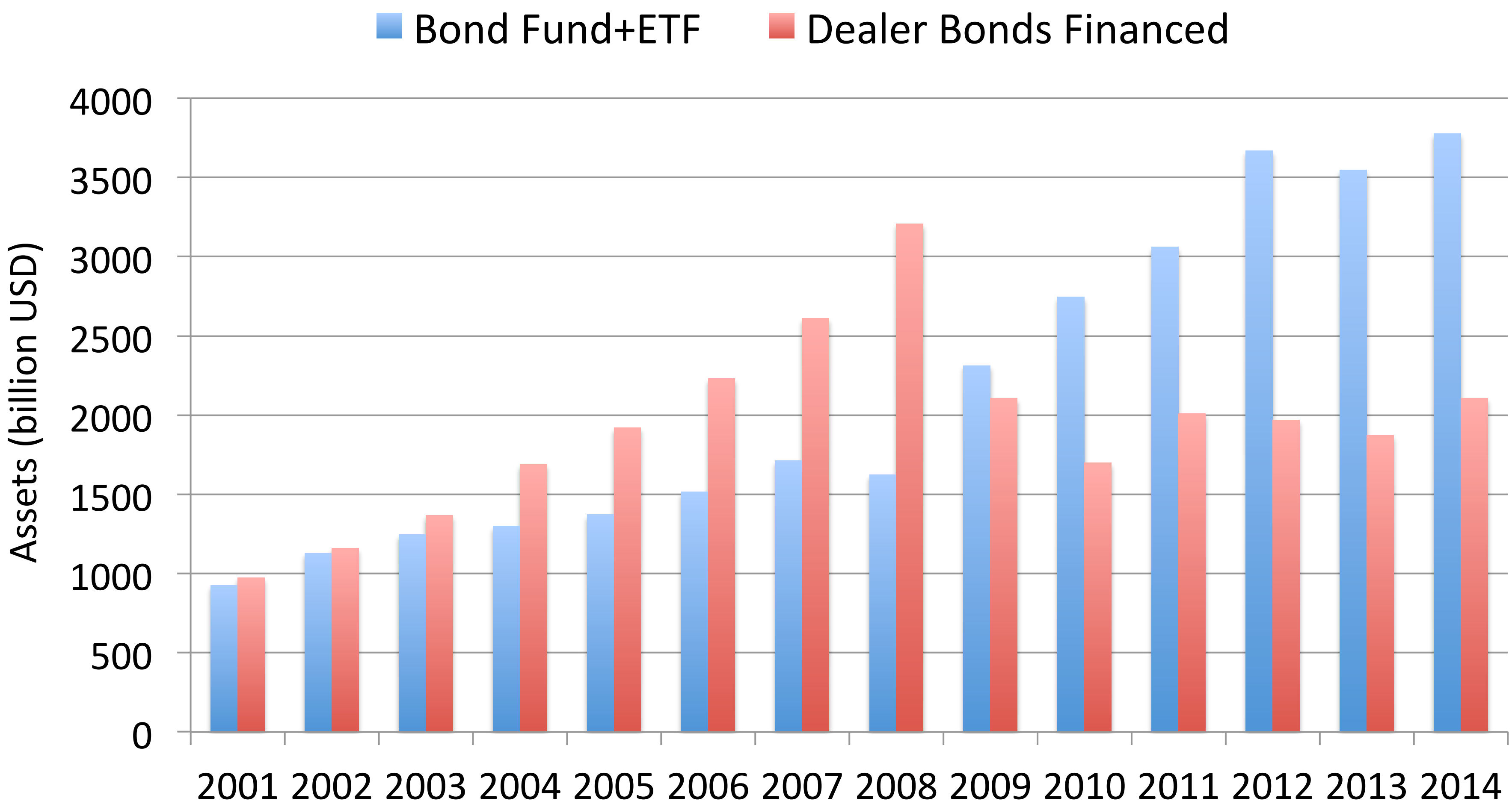


Number of CDS trades per quarter



Data source: DTCC

Who handles U.S. bonds?

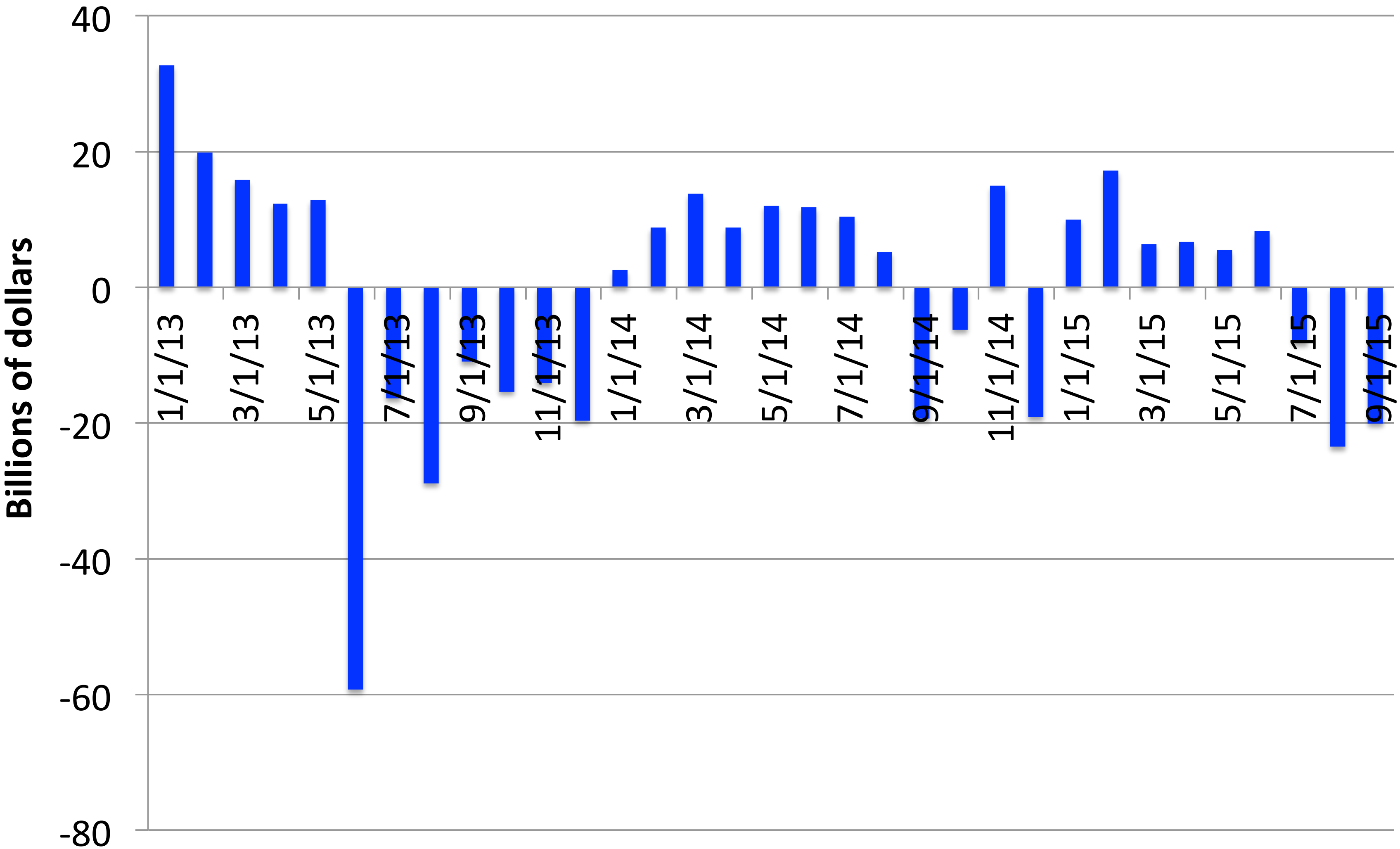


Data sources. ICI: AUM, bond mutual funds + ETFs. FRBNY: primary dealer daily financing (securities out) of UST + agencies + MBS + corporate bonds.

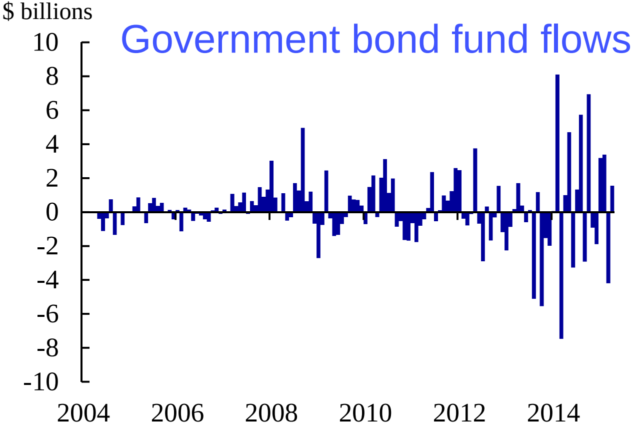
Asset management stability issues

- Comments on the risk of a crisis arising from sudden bond fund redemptions seem exaggerated.
- A rush for the exits would impact prices, but bids will likely arrive before a crisis is triggered. Who exactly would “fail”?
- Large hedge funds present a potential for unwind risk, given their reliance on leverage and expert portfolio managers.
- Large agency-based managers seem more benign, and have not been designated as SIFIs.
- Regulators also focus on insurance firms that are active in financial markets. Some have been designated.
- Money-market funds are migrating to government securities

Net monthly cash inflows to bond funds



Data source: Investment Company Institute



Note: Total net monthly flows; Some funds own agency debt securities and MBS in addition to Treasury securities

Source: Staff calculations, based on data from Morningstar.

Source: Joint Staff Report: The U.S. Treasury Market