Minutes of the May 22, 2020, Financial Advisory Roundtable Meeting

Present:

FAR Members: Viral Acharya, Hayley Boesky, John H. Cochrane, Bennett Golub, Robin Greenwood, Bradford Hu, Ralph Koijen, Deborah Lucas, Srini Ramaswamy, Antoinette Schoar, Til Schuermann, Jeremy C. Stein

FRBNY: John Williams, Gianluca Benigno, James Bergin, Nina Boyarchenko, Hunter Clark, Linda Goldberg, Beverly Hirtle, Anna Kovner, Lorie Logan, Don Morgan, Matt Plosser, Joshua Rosenberg, Joao Santos, Daleep Singh, Kevin Stiroh, Michael Strine, Andrea Tambalotti

Summary:

The Financial Advisory Roundtable ("FAR") meeting focused on the response of the Federal Reserve ("Fed") to the economic developments associated with the COVID-19 outbreak. The meeting consisted of two parts, each with three short presentations. In the first part, Til Schuermann, Viral Acharya, and John Cochrane discussed the Fed's response to the crisis, including whether the central bank should be more (or less) involved in risky financial markets. In the second part, Jeremy Stein, Antoinette Schoar, and Bradford Hu discussed what additional programs or actions the Fed should consider. Each set of presentations was followed by an open discussion of the topics.

Role of the Federal Reserve in responding to this crisis

FAR members began with a review of the Fed's response to the crisis. There was broad consensus that the Fed's fast and extensive policy actions had served to support U.S. households and businesses and to improve financial market functioning. At the same time, members raised the issue that the ultimate efficacy of policy actions depends on whether the crisis remains a short-lived liquidity crisis (V-shaped trajectory) or evolves into a long-lived solvency crisis (U- or L-shaped trajectory).

The scope and scale of the recently implemented emergency lending facilities was a central topic. On one hand, if the crisis is short in duration, lending can support otherwise solvent businesses to bridge liquidity and financing needs, thus avoiding costly layoffs and bankruptcies. For example, following the announcement of the corporate credit facilities, credit spreads declined and corporate bond issuance increased, helping to mitigate near-term financing risks for firms and their employees. On the other hand, if the crisis is long in duration and demand for businesses and services change, the liquidity crisis may evolve into a solvency crisis. In this case, fiscal rather than monetary interventions may be needed, such as programs to support labor reallocation, unemployment insurance, and the bankruptcy process.

The question of whether the central bank should be more (or less) involved in risky financial markets thus depends on the nature of the crisis and its associated risks. Under Section 13(3) of the Federal Reserve Act, the Fed may engage in broad-based emergency lending only in unusual and exigent circumstances with approval from the Treasury Secretary. The Fed is restricted to lend to only solvent institutions with enough security to protect taxpayers from losses. If the underlying default risk for the borrowers in a particular lending facility is high, FAR members indicated that the leverage for that facility should be low to protect taxpayers beyond the equity capital that is approved by Congress and provided by the Treasury Department. In practice, selecting the appropriate amount of leverage is challenging because there is large uncertainty regarding current default risk and there may be substantial variation in risk profiles for borrowers across lending facilities.

FAR members then considered implications of the crisis for the banking sector. It was noted that bank stocks have underperformed relative to the broader stock market since the start of the COVID-19 crisis and that firms have significantly drawn down their credit lines at banks, with the largest drawdowns coming from lower-rated, high risk firms. Some members indicated that financial sector weakness may not be a problem if the recovery is quick, but that banks may experience a substantial capital shortfall if the recovery is prolonged. These members suggested that restricting share repurchases and dividend payouts may not be sufficient to maintain a well-capitalized banking sector and that an early banking sector recapitalization may be desirable before the economic situation deteriorates further. An analogy was made to early 2008 and it was remarked that such a recapitalization would be in line with lessons learned from the great financial crisis (GFC).

Finally, some FAR members observed that emergency Fed interventions give rise to troublesome incentives. If market expectations become anchored that the Fed will intervene when economic disruptions loom, market participants may take excessive risk and leverage during normal times with the potential to exacerbate the business cycle. Two examples were cited: emergency lending to money market mutual funds, despite market reforms, and excessive leverage at hedge funds. While there was consensus that the Fed's actions were necessary in the current situation to provide liquidity support and prevent wider financial sector turmoil, a solvency crisis raises questions regarding what interventions should be taken by policymakers going forward to mitigate this dynamic.

Additional programs or market segments to consider

The second part of the meeting began with a general discussion on being the lender of last resort (LLR). The traditional LLR logic is that the central bank should provide liquidity to solvent firms by lending freely at a small penalty rate. In the current environment, several members observed that lending to only low-risk firms may result in small and restrictive programs.

Instead of the traditional approach, the suggestion was made to provide dynamic and staged financing. The first round would include broad and temporary lending to a large range of firms without imposing stringent ex-ante credit standards. This suggestion was motivated by the observation that many high-risk large- and medium-sized firms are not supported by current programs. A staged-approach might help to "flatten the bankruptcy curve", reducing inefficiencies associated with contemporaneous firm liquidations and the congestion of bankruptcy courts. Other members noted that the risk associated with a broader program would require authorization and fiscal support.

In addition, members observed that some programs such as the Main Street Lending Facility (MSLF) have rapid principal repayments, which may deter firms from participating or result in cash flow problems for those who do borrow. Some members also emphasized that holding senior claims in bankruptcy may result in difficult political economy trade-offs, as there may be an economic incentive aligned with that of other senior creditors to liquidate firms. The suggestion was made for the government to consider financing firms with more junior claims like preferred equity or warrants that could allow for flexibility such as the ability to defer interest payments without forcing default and to lessen debt overhang for firms to support a faster economic recovery.

The discussion then addressed the financing of small- and medium-sized enterprises (SME) and small businesses. FAR members argued that the structure of the Small Business Administration's Paycheck Protection Program (PPP) loans, including the first-come, first-serve basis, created competition that incentivized lenders to submit applications quickly on behalf of existing borrowers for whom it was faster to screen loans and to complete paperwork. FAR members argued that the competitive nature of the program led to a misallocation of credit, as borrowers who received the funds were not necessarily those who were hardest hit by the pandemic. There was encouragement to think of different ways to allocate liquidity and funds to small businesses, while simultaneously taking into account concerns about fraud and worries that the conditional nature of the current program, e.g. on continuing paycheck payments, is too restrictive. On a positive note, it was observed from anecdotal evidence that entrepreneurs are well capitalized by venture capital and that small merchant revenue has rebounded somewhat faster than expected as measured by monthly credit card data.

Turning next to the mechanics of other lending programs, FAR members observed that the Fed has been proactive and receptive to feedback on lending facilities. For example, the initial collateral constraints for the Term Asset-Backed Securities Loan Facility were limiting but quickly addressed. In addition, FAR members discussed the municipal bond market. Members observed that states and municipalities are large employers of U.S. households and that AAA-rated general obligation bonds are still trading at wide spreads and remain volatile relative to emerging market and high-yield bonds. Members also observed that some types of municipal finance, such as infrastructure projects, are not supported by current programs. At the same time, the complexity of the municipal market was acknowledged, including its large number of issuers and the complications that stem from disparate state and local laws that apply to different issuers. In this context, FAR members noted that the feedback, proposals, and perspectives on new lending programs are particularly valuable – as one size does not fit all across the various credit and liquidity facilities.

FAR members concluded the meeting by considering the role of emergency lending in the current environment. Some members noted that lending to avoid bankruptcy and labor reallocation costs must be weighed against potential loan losses and concerns about debt overhang and moral hazard. Other members highlighted further concerns, such as the high spread of mortgage rates to Treasuries and the rebound in stock prices despite the backdrop of uncertain and volatile fundamental cash flows. Finally, in relation to various proposals from the conversation, members observed that the Fed is subject to strict legal requirements for emergency lending under Section 13(3) of the Federal Reserve Act. If the recession worsens and solvency problems increase, fiscal solutions may be required.