

Fed report warns of “vulnerabilities” in US financial system

Nick Beams

May 7, 2021

The semi-annual Financial Stability Report, issued by the US Federal Reserve on Thursday, has warned that the rising debt of hedge funds, much of which is not recorded by regulatory authorities, poses growing risks for the stability of the financial system.

Key aspects of the report were highlighted in an introductory statement by Fed governor Lael Brainard, who chairs the Fed’s committee on financial stability. She noted that “vulnerabilities associated with elevated risk appetite are rising.”

The report said markets for short-term funding were now functioning normally, following the collapse of March 2020 and the turbulence of late February this year. However, “structural vulnerabilities at some nonbank financial institutions (NBFIs) could amplify shocks to the financial system in times of stress.”

In her statement, Brainard said valuations across a range of assets had continued to rise from their elevated levels of last year, with equity prices setting new highs. Relative to expected future earnings they were “near the top of their historical distribution.”

The appetite for risk had increased as the “meme stock” episode had demonstrated. This refers to the elevation of the share price earlier this year of the video games retailer GameStop, because of its promotion on Reddit and other social media platforms. This was despite the company’s business model experiencing significant difficulties.

Brainard said corporate bond markets were also seeing “elevated risk appetite” with the difference between the interest rates on lower quality speculative-grade bonds and that of Treasury bonds among the lowest ever seen.

“This combination of stretched valuations with very high levels of corporate indebtedness bear watching because of the potential to amplify the effects of a repricing event,” she said. In other words, a rapid downturn in one area of the market would be rapidly transmitted through the financial system.

Brainard pointed to the failure in March of the family-owned hedge fund Archegos Capital, leveraged by banks to the tune of \$50 billion, and the associated losses suffered by those banks. It highlights, she said, “the potential for nonbank financial institutions such as hedge funds and other leveraged investors to generate large losses in the financial system.”

The Archegos event illustrated “the limited visibility into hedge fund exposures and serves as a reminder that available measures of hedge fund leverage may not be capturing important risks.”

Reading between the lines, the meaning of this statement is that the Fed is concerned that there are more Archegos Capitals out there, but it has no real idea of where they are or the level of bank exposure to them.

Brainard noted that the “potential for material distress at hedge funds to affect broader financial conditions underscores the importance of more granular, high-frequency disclosures.”

The report pointed to numbers of areas of potential instability and how it could be transmitted.

“Bank lending to NBFIs represents a potential channel for transmission of stress from one part of the financial system to another. Committed amounts of credit from large banks to NBFIs, which consist mostly of revolving credit lines and include undrawn amounts, increased in the latter part of last year and reached a record \$1.6 trillion by year-end.”

Under the heading “Funding Risk,” the report said that in 2020 the amount of liabilities “potentially vulnerable to runs, including those of nonbanks, is estimated to have increased by 13.6 percent to \$17.7 trillion,” an amount equivalent to about 85 percent of GDP.

It said “structural vulnerabilities” remain at NBFIs, including at money mutual funds and “regulatory agencies are exploring options for reforms that will address those vulnerabilities.”

The admission that nothing is in place at present underscores one of the key features of the financial system. Every time the Fed or other regulatory bodies attempt to put a check on, or even exercise oversight over, some of the more speculative operations, market operators devise new ways to get around them.

In setting out the near-term risks to the financial system, the report said that if the pandemic persisted longer than anticipated, especially in the event that new variants of the virus emerged, then it could derail the recovery in the US economy.

“If those developments occurred, a number of vulnerabilities... could interact with the negative shock to the economy and pose additional risk to the US financial system.”

While leverage was low at banks and broker dealers, “the leverage of some NBFIs, such as life insurance companies and some hedge funds is high, exposing them to sharp drops in assets prices and funding risks.”

It noted that, because European banks play an important role in the global financial system and have “notable financial and economic linkages” with the US, financial stress in Europe resulting from a continuation of the pandemic could also have a negative effect.

Likewise, if emerging market economies face a rise in interest rates not accompanied by an improvement in the global economic outlook, this could impact on US financial firms that have strong links with these countries and their companies.

Commenting on the Fed report, George Selgin, a senior fellow at the free-market Cato Institute, pointed to some of the inherent conflicts arising from the Fed's policies as it continues to pump money into the financial system.

“The real story here is the tension—if not the glaring contradiction—of the Fed's pursuit of quantitative easing (QE), the aim of which is to lower long-term rates and encourage reach for yield, and their concern that people are indeed reaching for yield,” he told Bloomberg.

The tension arises from the fact that while the stated intention of the ultra-low interest rate regime is to promote greater risk-taking through investment in the real economy—the financing of productive activity, real investment in plant, equipment and technology—the vast bulk of the money is being used to fund speculation in increasingly risky financial assets.

Selgin called for the Fed to “taper its QE activities to counter this risk-taking as the recovery continues.”

However, the financial system has become so dependent on the continued inflow of essentially free money that any move in this direction could ignite a major crisis.