

## Minutes of the April 18, 2023, Financial Advisory Roundtable Meeting

### Attendance (Physical and Virtual):

**FAR Members:** Viral Acharya, Hayley Boesky, John Cochrane, Keishi Hotsuki, Maureen O'Hara, Christine Parlour, Thomas Philippon, Srinivas Ramaswamy, Jeremy Stein, Joanna Welsh

**New York Fed Staff:** **Chair: John Williams,** Jason Abel, Ozge Akinci, Martin Almuzara, Mary Amiti, Kristian Blickle, Nina Boyarchenko, Marco Cipriani, Hunter Clark, Adam Copeland, Rita Csejtey, Marco Del Negro, Leonardo Elias, Michael Fleming, Linda Goldberg, Tiffany Hewlin, Bev Hirtle, Darau Johnson, Hyeyoon Jung, Tom Klitgaard, Anna Kovner, Gabriele La Spada, Eric Lewin, Jim Mahoney, Antoine Martin, Jonathan McCarthy, Meg McConnell, Susan McLaughlin, Helen Mucciolo, Wing Oon, Roberto Perli, Matthew Plosser, Julie Remache, Joshua Rosenberg, Joao Santos, Asani Sarkar, Lee Seltzer, Or Shachar, Katherine Tilghman-Hill, Giorgio Topa, Emily Yang, Joshua Younger

### Agenda:

The meeting was focused on (i) discussions of bank stability in the face of high rates and following the Silicon Valley Bank (SVB) failure, (ii) the provision of credit, and (iii) how to interpret financial indicators. Participants were presented with the following questions to consider ahead of the meeting and structured their discussion around:

1. How have financial conditions responded to the elevated rate environment and recent events in the banking sector?
2. How should Central Banks interpret and use financial conditions indicators? What are the implications for forecasting economic activity and deciding monetary policy stance? How does tightening the policy rate differ from a reduction in lending supply?
3. Have changes in the financial sector (e.g., growth in nonbank intermediaries) impacted the speed or level of transmission to financial conditions?
4. Are there lessons we can learn thus far about implementation (e.g., Interest Rate on Reserve Balances, Overnight Reverse Repo Facility) and efficacy of policy rates as it relates to financial markets?

The meeting began with Introductory remarks, followed by a reminder from New York Fed Staff that FAR Members must adhere to and should review the [Antitrust Guidelines for Members of New York Fed's Advisory and Sponsored Groups](#), which were included in the meeting invitation.

The meeting then included two presentations: (1) John Cochrane discussed challenges of inflation control when real rates are below inflation rates and when fiscal policy is not aligned with monetary policy; (2) Srinivas Ramaswamy presented his perspective on financial conditions and policy transmission. The presentations documents are attached. These presentations were followed by an open discussion on the topics listed on the meeting agenda.

### **Bank stability following the failure of SVB and successive rate hikes:**

FAR members began with a discussion of bank stability. Members were in general agreement that the behavior of bank depositors has changed since the failure of SVB. Competition from Money Market Mutual Funds (MMF), whose yields respond more elastically to monetary policy changes than deposit rates, and concerns about the stability of mid-sized banks have led to sizable deposit outflows from the banking sector.

Some members highlighted the continuing pressure of interest rates on bank profitability on asset values (i.e., interest rate risk) and the ability of banks to earn significant returns. In response, others pointed out that the realization of these risks depends on the behavior of depositors. There was a brief discussion of the current sensitivity of deposit rates to interest rates, the so-called deposit betas. During the discussion, some members suggested that banks would have to begin paying higher rates to retain depositors in the face of depositor outflow pressures. Some participants suggested that the current turmoil in the banking sector may have made depositors more aware of alternative deposit-like investment opportunities, making them more responsive to price changes. For example, to retain depositors, the higher deposit rates would have to correlate with the rates paid by MMFs. As such, the outflow pressure experienced by banks would lead, indirectly, to better monetary policy transmission as the fed funds rate translated more directly to the rates experienced by depositors.

An added risk, which was discussed by members, was that of small and medium-sized enterprises (SMEs) moving their payroll and payment processes away from (smaller) banks to other, nonbank firms that specialize in this type of work. This conversation on a potential SME depositor exodus dovetailed with a discussion on whether regulation should treat different types of depositors differently. After all, not all depositors behave the same way or use banking service for the same purposes.

Finally, FAR members transitioned to a discussion of the credit cycle and credit provision. Members suggested that credit provision has been slowing as indicators have suggested a tightening for some time. This credit reduction may now be exacerbated by banks wishing to hold additional liquidity following depositor reshuffling and general interest-rate uncertainty.

### **Understanding the financial outlook based on mixed indicators:**

FAR members discussed the challenges in understanding financial conditions indicators – and whether the US has entered a (banking) crisis – as standard metrics are presenting mixed signals. Overall, participants noted that financial condition indicators are limited. One participant noted that indicators often rely on credit spreads which struggle to reflect liquidity risks.

Participants noted that lending has tightened less than expected thus far in response to rate hikes. Moreover, overall consumer spending remains higher than pre-COVID levels, even if a slowdown has been detected. Similarly, while wage growth has slowed down, especially among higher income households, it remains elevated.

FAR members cited survey data that indicated a more bearish outlook by key market participants and lending institutions. Based on popular metrics, a slowdown due to a credit contraction may be expected

as key rates have reached historically terminal levels. However, this reduction in growth may be different for different sectors. Members discussed weakness in the tech sector and the commercial real estate sector as potential sources for concern.

Some FAR members suggested that it is unclear whether real rates were positive and whether this was a necessary condition for reducing inflationary pressures. This uncertainty prompted FAR members to generally discuss the challenges of managing the interplay between financial stability risks and inflationary pressures.

FAR members concluded the meeting by revisiting the discussion of which indicators are most suited to managing the credit cycle and broader financial conditions. Members agreed that the next crisis will not be like the last and that there may be risks driven by factors that remain poorly understood.

### **Other comments**

Participants raised concerns that current events could echo the S&L crisis, with certain banks taking on undue risks to pay higher interest rates and remain competitive. Participants, however, did not have a uniform outlook on the likelihood of such a crisis repeating itself. Some participants noted that a difference relative to the S&L crisis is the presence of FinTech, which could affect the stickiness of bank deposits and, as a result, banks' profitability and their risk-taking incentives. In this debate, the ability of banks to pay higher rates (in the near term) was brought up along with possible changes to liquidity regulation and deposit insurance schemes.

Some participants pointed to the concept of excess deposits – whereby a bank must maintain a certain deposit level to function effectively where deposits above this level are “excess”. Excess deposits can have a different beta without imperiling the bank. At present, larger institutions have significant excess deposits, while some smaller institutions have come closer to their thresholds for a minimum deposit level. This risk is bank specific and largely a function of the business-model.