**Minutes of the June 7, 2019, Financial Advisory Roundtable Meeting**

**Present:**

FAR Members: Hayley Boesky, John Cochrane, Bennett Golub, Robin Greenwood, Bradford Hu, Deborah Lucas, Lynn Paquette, Monika Piazzesi, Srini Ramaswamy, Tano Santos, Antoinette Schoar, Til Schuermann, Jeremy Stein, Heather Tookes.

FRBNY: James Bergin, Stein Berre, Nina Boyarchenko, Nicola Cetorelli, Marco Del Negro, Dianne Dobbeck, Fernando Duarte, Kevin Duffy, Thomas Eisenbach, Linda Goldberg, Michael Held, Beverly Hirtle, Sandra Lee, Haoyang Liu, David Lucca, Stephan Luck, James Mahoney, Meg McConnell, Jordan Pollinger, John O'Sullivan, Joshua Rosenberg, Joao Santos, Argia Sbordone, Michael Schetzel, Patrick Steiner, Andrea Tambalotti, Peter Van Tassel, James Vickery, Desi Volker, John Williams.

**Summary**

The discussion at the Financial Advisory Roundtable ("FAR") meeting focused on the credit cycle, including a discussion of the causes and measurement of the credit cycle, the current state of the credit cycle, and the appropriate role of public policy. The meeting included two presentations: (1) Robin Greenwood discussed credit market overheating and determinants of the credit cycle, (2) Til Schuermann discussed the role of banks in the credit cycle and considered how this role may be affected by post-crisis changes in financial regulation and other factors.

**Causes and Consequences of the Credit Cycle**

FAR members considered how closely the credit cycle commoves with the business cycle, and to what extent the credit cycle is affected by other independent factors. It was suggested that the credit cycle lags the business cycle on average, and a number of explanations were offered for such a lag. Some FAR members highlighted that financial factors related to the credit cycle have predictive content for macroeconomic activity: measures discussed included the growth of various types of credit, sentiment measures, credit spreads, and leverage.

FAR members advanced a range of alternative explanations for the origins of credit cycles, including theories based on behavioral factors and theories based on frictions in the economy or financial markets. One behavioral theory that was discussed is the idea that the biased beliefs of economic agents can create a feedback loop with markets that can be destabilizing (e.g., if individuals extrapolate recent past trends when forming beliefs about the future). FAR members also suggested a number of frictional factors which could help explain patterns in the credit cycle, such as regulation, financial constraints facing financial intermediaries, and the short horizons of some types of investment managers. Other FAR members argued, however, that credit cycles can be understood without behavioral or frictional theories.

Several participants highlighted the difficulty of distinguishing speculative bubbles from credit booms driven by innovation or strong economic fundamentals. FAR members also argued that credit booms can be beneficial, for example by allowing financing of highly risky projects and relaxing constraints in the economy, such as the effective lower bound on interest rates. The discussion about the costs of booms generally revolved around the potential for crisis after "excessive" credit, and the role of quantities versus prices, and supply versus demand, in assessing the state of the credit cycle.

## Current Trends and the State of the Credit Cycle

FAR members discussed recent trends in US corporate credit, including the rapid growth in leveraged loans and "cov-lite" loans (loans featuring few covenants protecting the lender). A range of views were expressed about whether corporate debt markets are significantly overheated. Some FAR members expressed concern about the deterioration in the quality of investment grade corporate debt, especially the lower rated portion. It was suggested that the trend towards cov-lite lending makes corporate loans more similar to bonds, and that it is appropriate to analyze trends in the two markets jointly.

FAR members also discussed recent trends in household debt. Participants highlighted the rapid growth in student loans, but suggested that this market may be relatively less susceptible to a sudden drawback in credit availability because most loans are provided by the government rather than private financial institutions. Participants also noted that government plays important role in determining credit availability in the US mortgage market, attenuating risk pricing in that market.

One FAR member emphasized heterogeneity and the importance of examining trends for the entire distribution of borrowers – for both households and firms – in assessing current credit conditions. In this light, concerns were expressed about the concentration and performance of consumer debt among low income households and minorities. It was also suggested that the use of machine learning in loan underwriting has the potential to increase predatory lending to less sophisticated borrowers, and could also have other effects on credit provision and the credit cycle.

FAR members also considered the role of banks in the credit cycle. It was argued that even though overall capital at large banks is high compared to pre-crisis levels, the perceived "headroom" above regulatory requirements is now lower, and that this could constrain bank behavior during a future downturn in the credit cycle. Some participants also expressed concerns about the measurement of bank capital adequacy, noting that banks were believed to be well-capitalized prior to the 2008 financial crisis based on measures of regulatory capital in force at that time. Stress testing was highlighted as a key post-crisis regulatory initiative in affecting capital allocation and lending by banks over the cycle. Participants also discussed the introduction of current expected credit loss (CECL) as a methodology for bank loan loss provisioning, and the extent to which CECL may be less procyclical than the current incurred loss approach.

Meeting participants discussed financial stability implications of the rapid growth in nonbank credit provision in recent years, a trend which was ascribed in part to tighter bank regulation. FAR members also discussed how the availability of market-based finance and non-bank finance can rapidly decline during downturns, and one participant suggested that an evaluation of bank capital adequacy should consider the ability of banks to pick up "slack" in credit provision during such periods.

## Policy Considerations

FAR members expressed a range of views about the appropriate role for prudential regulation, macroprudential policy and monetary policy over the course of the credit cycle. Some members argued that public policy should focus on building a resilient financial system rather than attempting to manage the credit cycle. Discussion about prudential regulation stressed the interaction between credit and liquidity, and the role of capital. Some participants advocated higher capital requirements for financial intermediaries. Other participants lay emphasis on the need to think about recapitalization after a crisis, and some suggested conducting stress tests on recapitalization plans. In the discussion of macroprudential policy, some participants noted that the US does not have as many macroprudential tools as other countries and that some of them have not yet been tested in practice.

There was an active debate on the role of monetary policy and whether a financial stability objective should be part of the central bank's objective and/or mandate. Some FAR members argued that monetary policy should only respond to financial and credit market variables to the extent that they provide information about the range of outcomes for future inflation and employment. It was suggested that if the credit and business cycles move closely together, then there is no conflict between the Federal Reserve's dual mandate and financial stability concerns. Other members argued that a focus only on inflation and output objectives could sometimes lead to large accommodation that could have undesirable effects on financial stability, particularly if inflation is relatively insensitive to changes in the unemployment rate. These participants argued that in such circumstances it is appropriate for monetary policy to take financial stability considerations into account.