A Commission staff report examines interdependencies in the $54 trillion U.S. credit markets and how stresses in those markets were exposed and addressed during the COVID-19 pandemic.

The SEC has published a staff report examining the interdependent structure of the U.S. credit markets and how those markets responded to both the economic shock caused by COVID-19. According to the Commission, the report seeks to identify key interdependencies and stresses in the credit markets in order to inform policy decisions aimed at improving market stability and resilience. While claiming to eschew making policy recommendations, the staff report credits the actions of the Federal Reserve as well as those Congress through the CARES Act with stabilizing markets and consumer confidence in the wake of the pandemic.

"Due to the interconnected nature of our credit markets and the size and scope of the COVID-19 shock, it was insightful, prudent and, perhaps, essential that the actions of the Federal Reserve and the CARES Act were multi-faceted and immediate," said SEC Chairman Jay Clayton and SEC Chief Economist S.P. Kothari in a letter accompanying the report. "Those actions were instrumental in ameliorating stress in the credit markets, particularly the short-term funding markets."

In their letter, Clayton and Kothari welcomed public comment on the staff report. In addition, the Commission announced that a public roundtable will be held on October 14 to discuss the findings. The event will be streamed live on SEC.gov and will feature a fireside chat with Clayton as well as two panel discussions.

The report's analysis uses the effects of the COVID-19 pandemic as a case study to illustrate the interconnections and related interdependencies in the $54 trillion U.S. credit markets, which have changed significantly in size, structure and function since the 2008 global financial crisis. The report identifies and examines in detail six key markets that cover $44 trillion of outstanding credit: (1) the short-term funding market (STFM); (2) the corporate bond market; (3) the leveraged loan and collateralized loan obligation (CLO) market; (4) the municipal securities market; (5) the residential mortgage and other consumer lending markets; and (6) the commercial mortgage market.

**STFM.** The report finds that COVID-19–induced stress on the financial markets falls into three categories. First, the approximately $10 trillion short-term funding market experienced significant stress in March 2020 almost immediately following the inception of the COVID-19 economic shock. Among other effects, yields rose across the length of the yield curve, volatility spiked, and credit spreads and bid-ask spreads widened. These effects of COVID-19 disrupted the orderly functioning of the STFM, leading to higher funding costs, a further increase in bid-ask spreads, and increased margin requirements and collateral haircuts, the report states.

For example, many investors seeking liquidity sold U.S. Treasuries because they have historically been the most liquid and the least price-affected securities in their portfolios. The combination of elevated uncertainty and the rush for liquidity eventually led to higher bid-ask spreads and to substantial changes in the relationships between "on the run" and "off the run" Treasuries and between cash and futures markets. Similarly, the agency mortgage backed security (MBS) market experienced increased economic uncertainty, higher yields, and selling pressure as market participants sought liquidity. The Federal Reserve’s direct intervention, including purchasing both Treasuries and agency MBS, in conjunction with regulatory actions such as providing interim capital relief to
banks to expand their ability to engage in market intermediation, helped to stabilize both of these markets, the report states.

**Market structure/liquidity driven stresses.** The report also finds that the market structure of certain segments of the credit market, including municipal credit and corporate credit, contributed to the market stress related to the COVID-19 economic shock. While the corporate and municipal markets are generally characterized by widely distributed and diversified ownership of credit, they also contain very large numbers of relatively small issues and investors. As a result, secondary trading in the cash markets for individual securities and loans is sparse and the amount of capital devoted to intermediation is limited, resulting in relatively low levels of liquidity compared to market size. The large, simultaneous redemption shocks caused by the COVID-19 shock strained liquidity, a strain exacerbated by the fact that, in the face of the severe buy-sell order mismatch, dealers may also have been reluctant to buy and meet sellers’ liquidity needs.

The Federal Reserve’s introduction of the corporate credit facilities and other actions (including purchasing ETFs) were instrumental in stabilizing the corporate bond market, the report explains. In addition, the price and consumer confidence stabilizing actions of the Treasury and Congress through the CARES Act added further stability both the corporate and municipal securities markets, including the market for new issues.

**Long-term credit stresses.** While the long-term economic impact from COVID-19 is still playing out and the long-term effects are difficult to predict, the performance of certain key long-term credit markets in periods of severe stress warrants further monitoring and analysis, the report notes. The report points out that long-term credit—including residential and commercial mortgages, corporate bonds and leveraged loans, and municipal bonds—accounts for a large fraction of the credit in the U.S. financial system. In times of stress, these markets become significantly more affected by and interconnected with the performance of other markets, particularly the short-term credit markets.

The report observes that banks have not experienced significant balance-sheet stresses in coping with the general economic shock because they were well capitalized and generally were not carrying large inventories of credit-sensitive instruments. This institutional stability, combined with and enhanced by the actions of the Federal Reserve and other governmental actions, in particular the CARES Act, has enhanced market stability. Long-term uncertainties about the economic effects of COVID-19 on the performance of credit remain, however. In addition to credit exposure, banks’ performance and health more generally depend on the economic health of their borrowers. Accordingly, banks and other financial institutions remain exposed to potential long-term adverse economic effects related to COVID-19.

Extended disruption from COVID-19 could also cause financial stress in the corporate bond market. Longer term stress could lead investors—for example, insurance companies and pension funds—to incur significant losses if corporate bonds are downgraded and repriced. Moreover, it is important to note that many of the investors in longer term credit operate with leverage, and the risk profile of the leveraged loan and CLO market has increased in recent years. While the COVID-19 economic shock to date has not appeared to significantly impair the CLO market, if leveraged issuers suffer financially in the future, their defaults could adversely affect CLO prices and potentially create defaults in the lower-rated tranches of the CLO securities.

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