FedFin Client Report

Wednesday, November 18, 2020

OFR Offers New Vision of Systemic-Risk Analysis, Financial-Stability Impact

Client Report: **SYSTEMIC90**

Executive Summary

The Office of Financial Research's latest systemic-risk assessment reiterates much of the market analysis in the FRB's recent report (see *Client Report* **SYSTEMIC89**), the FSB's analysis (see *Client Report* **NBFI**), and the OCC's risk matrix. Further, OFR's analyses have less policy impact especially in light of the pending Administration change. Nonetheless, its conclusion – that no prior metrics or models proved their predictive power when COVID hit – reflects considerable internal thinking at U.S. and global agencies. As OFR now notes, many analyses up to the point at which the financial system collapsed in March judged systemic risk as "moderate" or better. This FedFin report thus assesses OFR's work in novel areas, which does not view the unlikely event of a pandemic as an excuse for prior analytical errors given the well-accepted potential for pandemic risk at any point in time. The report also adopts a novel approach to defining financial stability, moving beyond an assessment of financial-services firms and markets to define financial stability as a system that ensures economic opportunity.

Analysis

The bulk of the OFR report details developments in the wake of COVID's market crash, reiterating events such as MMF outflows and hedge-fund leverage in the Treasury market without drawing clear conclusions from them. Key OFR conclusions include:

- Credit risk remains an acute concern, with banks noted as among entities vulnerable to market-pricing changes and other hazards as loan losses increase. The report also details heightened banking-sector market risk, although liquidity and funding risks are said to be moderate. This echoes a recent FRB-NY blog post. In contrast to the FRB-NY, OFR believes financial system leverage is acceptable and insolvency and contagion risk are "contained" within the financial system.
- Nonetheless, OFR predicts a wave of corporate defaults that could overwhelm the U.S. bankruptcy system. CRE risk is an acute concern and poses significant risk to small-and-medium banks and specialized lenders. The GSEs are not at significant

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

risk due to secure funding, nor are large life insurers at acute risk due to conservative financing practices.
- Household financial vulnerability is uneven, but financial stimulus and relatively low levels of household leverage suggests limited systemic risk.
- The U.S. financial system is at material cyber risk.
- Information and “predictive” markets” or other forecast methodologies that do not depend on regulatory assessments and their impact on regulated banks could improve systemic-risk identification.

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