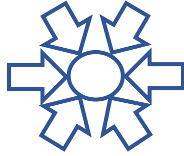

FedFin Client Report

Tuesday, May 10, 2022

Fed is Cautiously Optimistic re U.S. Systemic Risk

Client Report: SYSTEMIC93

Executive Summary

In this report, we assess the new Federal Reserve financial-stability report. Secretary Yellen is also testifying now about systemic risk and sure to get questions on the Fed's conclusions. We will shortly send you an in-depth report on this hearing, but key to the Fed's report is a more cautious, but still sanguine outlook. For example, banks are found to be resilient and well-capitalized despite growing Fed concern about indirect risk channels such as asset-market volatility, sanctions-related disruptions to payment, settlements, and clearing, and inter-connections with large European banks. Life-insurance companies and hedge-fund leverage remains a significant concern, although the Fed finds that at broker-dealers and P&C insurers is well within reasonable range. As detailed below, the FRB is still concerned with MMF-liquidity risk, favoring the swing-pricing reforms if "properly calibrated" in the pending SEC proposal (see FSM Report **MMF19**) along with urging continued attention to bond and open-end funds. The report also includes a synopsis of the Fed's CBDC discussion draft (see FSM Report **CBDC10**), suggesting it might reduce systemic risk without reaching any conclusions ahead of ongoing Board review. Near-term risks in areas such as cyber-security are heightened due to Ukraine and financial stability could be threatened through "multiple channels" despite resilience to date. Elevated and persistent inflation would also prove a near-term stability risk. Still, the Fed seems confident that none of these is risks will prove unmanageable.

Analysis

In addition to the overall findings noted above, the Fed's key conclusions are that:

- Despite elated risks, credit growth compared to GDP continues to shrink. This contrast is likely to make the Fed still more averse to invoking counter-cyclical capital buffers based on the credit: GDP criterion in the Basel rules (see FSM Report **CCYB**).
- Commodity markets are vulnerable due to CCP margin calls. Bank credit risk is not likely to be problematic, but liquidity and market risk could rise sharply given ongoing market volatility.
- Structural liquidity vulnerabilities remain high at some MMFs, open-end funds, bond funds, and stablecoins. The total amount of financial assets subject to runs increased

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6.3 percent in 2021 to $19.1 trillion or about eighty percent of nominal GDP. Banks remain resilient to liquidity risk.

- There is a risk of EME or China market risk spilling over to the U.S.
- The transition from LIBOR is largely complete, although more work is needed in exchange-traded futures and options.
- Corporate credit quality and interest-coverage ratios are sound, although data exist only on publicly traded firms.
- Household financial condition is generally strong, with borrowing concentrated in low-risk households and household credit risk generally low; although mortgage forbearance may have helped some households handle inflationary-cost increases without new borrowing in ways that will cease as forbearance ends. Despite near-term forbearance termination, student debt is not a systemic risk since most of it is government-issued and held by households in the top forty percent of income distribution.

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