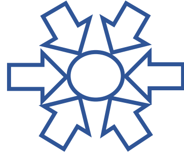

FedFin Client Report

Monday, December 19, 2022

FSOC Targets Usual Suspects but Also Points to Big-BHC, Nonbank Mortgage Systemic Risk

Client Report: FSOC28

Executive Summary

As promised, this FedFin report provides an in-depth analysis of FSOC's 2022 annual report, focusing on findings with near-term policy implications. As always, the report is lengthy and includes many observations and market details that provide insight into Treasury and member-agency-staff thought. Much in it reiterates concerns about short-term funding markets, CCPs, and investment funds (with FSOC for the first time urging regulators to look not only at MMFs and OEFs, but also at collective investment vehicles). As previously noted, the report is relatively sanguine about digital-asset systemic risk but, also reiterates findings in FSOC's report (see *Client Report* **CRYPTO33**) demanding rapid action on a raft of reforms in this high-risk sector. What surprised us is the discussion of large BHCs, which departs from longstanding Fed and FSOC comfort in the post-GFC regulatory regime for this sector. FSOC does not doubt increased bank resilience, but it is worried that bank capital may not withstand stress and urges attention to unrealized losses, the extent to which stress-test scenarios are sufficiently robust, and the need for additional loan-loss reserves. We believe this new approach reflects a like kind shift at the Fed under Vice Chairman Barr. The discussion of nonbank mortgage originator/servicer systemic risk is not new, but the focus now on the need for stress-testing is. The report does not emphasize the calls for systemic attention to cloud-service providers and the payment system identified in CFPB Director Chopra's written statement for the FSOC, although these issues are noted as potentially problematic.

Analysis

The report highlights fourteen systemic vulnerabilities and risk-reducing recommendations. These are summarized below:

1. Financial Risks

These are:

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

© 2022. Federal Financial Analytics, Inc. All rights reserved.

- **CRE and Residential Real Estate:** These are a significant risk due to scale and leverage. Supervisors and institutions are told to monitor exposures and loan-loss allowances and improve CRE underwriting and stress planning. As noted below, a major concern regarding residential real-estate exposures is the extent to which nonbank entities will prove resilient under stress. FSOC also shares the BIS's worries about MBS-market stability. FSOC also urges the agencies to ensure that mortgage loss-mitigation strategies will prove resilient in a high interest-rate environment, taking supervisory action as needed.

- **Non-Financial Borrowers:** Regulators are told to monitor leverage along with exposures and to "encourage" entities exposed to corporate credit risk to review risk-rating and loan-loss methodologies.

- **Short-Term Funding Markets:** Here, FSOC recommends close monitoring and supports ongoing efforts to strengthen market functioning. As with the Inter-Agency Working Group (see *Client Report* **TMARKET2**), FSOC also wants more data.

- **Digital Assets:** FSOC also reiterates its prior backing of the SEC's approach to immediate enforcement, agreeing also to CFTC regulation for certain spot-market offerings, ending regulatory arbitrage, and addressing vertical integration.

2. Financial Institutions

Here, FSOC targets:

- **Large BHCs:** FSOC wants BHCs and supervisors to assess capital adequacy with particular attention to unrealized losses, stress-test scenarios to ensure that these are sufficiently rigorous, and NBFI exposures with particular attention to liquidity mismatch. FSOC is also concerned about heightened operational risk related to evolving technology and delivery channels.

- **Investment Funds:** Here, FSOC reiterates concerns about MMFs, OEFs, hedge funds, and other vehicles, supporting recent SEC initiatives and suggesting the need for additional action. This would address the extent to which collective investment funds differ from OEFs and thus require more regulation.

- **CCPs:** Noting that CCPs stand firm under stress largely by passing risk on to others, the Council recommends that the CFTC, FRB, and SEC continue to coordinate FMU supervision and work with the FDIC on resolution planning.

3. Financial Market Structure

Risks of concern here are:

- **Treasury Market**: Discussion here follows many prior U.S. statements.

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

© 2022. Federal Financial Analytics, Inc. All rights reserved.

- **LIBOR Transition:** Again, there is little new here in statements urging rapid transition.

- **NBFIs:** Agencies are asked to "leverage" their authority to adopt a same-risk, same-rule construct and to work with state regulators to strengthen standards for nonbank mortgage of mortgage servicers and originators, with discussion here suggesting stress-testing for the largest firms.

4. Operational Risk

Cyber-security is a top priority, with the Council also concern about third-party service providers. Suggestions that the banking agencies finalize long-pending third-party standards (see FSM Report **VENDOR9**) is now toned down to recommendations that the agencies work together and with the states, also noting FSOC's perennial request that Congress grant FHFA like-kind authority.

5. Climate Risk

This discussion repeats many prior FSOC statements about climate risks' potential severity and the need for agencies to address it without adding any new specific recommendations.

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

© 2022. Federal Financial Analytics, Inc. All rights reserved.