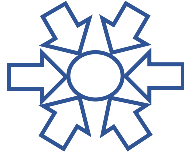

# FedFin Client Report

**Tuesday, May 9, 2023**

## Fed Frets About Banks, Nonbanks, Hedge Funds

**Client Report: SYSTEMIC96**

## Executive Summary

Perhaps because its last financial-stability report (see *Client Report* **SYSTEMIC94**) was contradicted just five months later by a systemic-risk designation, the Federal Reserve's latest report eschews a conclusion about prospective risk in favor of a review of current concerns. As noted upon the report's release, these include a somewhat less effusive view of bank resilience than has characterized prior reports but the Board nonetheless views the banking system as sound and recent failures as essentially idiosyncratic. The report is, however, concerned with midsized-bank CRE concentrations and the near-term impact of macroeconomic factors and deposit outflows on credit availability, noting as Chairman Powell did last week that this could adversely affect economic growth. The report unsurprisingly supports FSOC's ongoing consideration of the systemic threat posed by nonbank mortgage companies and hedge funds (see FSM Report **SYSTEMIC95**), although concerns about mortgage companies are premised on risks related to higher delinquencies that lead banks to curtail funding rather than direct inter-connection or structural risk. The report also reiterates longstanding Fed fears regarding MMF and OEF run-risk, CCP resolvability, and life-insurance companies. This report details the Fed's reasoning on these issues along with other key conclusions; none of which seems likely to alter the course of near-term financial policy.

## Analysis

Much in this report, as others, provides an array of market statistics without conclusions as to why these may be evident. Conclusions provided include:

- Almost all new originations and risk trading have moved to SOFR following an inter-agency statement that failing to do so could be deemed a safety-and-soundness violation. While significant problems in legacy-contract rate conversions continue, the Fed does not appear to view this as a systemic risk due to an array of transition arrangements detailed in the report.
- CRE valuations remain high despite clear signs of distress, suggesting that revaluation could be significant and sudden. Mid-sized banks and insurance companies are at greatest risk, but some REITs, private-equity firms, and other nonbanks 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

© 2023. Federal Financial Analytics, Inc. All rights reserved.

significantly exposed to lower-tranche CMBS. The Fed is increasing examinations at banks with concentrated CRE positions.

- Despite recent failures, the banking system is strong. More than 45 percent of bank assets mature or reprice within a year, reducing HTM stress despite significant asset accumulation in this category ($2.3 trillion in 2020 and 2021). The Fed's description of recent bank failures aligns with its report on SVB (see *Client Report* **REFORM221**) and the FDIC's on Signature (see *Client Report* **REFORM222**).
- Life-insurer leverage is in the mid-range, but asset holdings are high risk and could be subject to significant valuation risk.
- Leverage at the largest hedge funds has risen significantly, contributing to Treasury-market illiquidity and overall market volatility.
- Private credit fund systemic risk is "limited," but that to NBFIs has risen forty percent year over year and is a growing concern. Nonbank mortgage companies are highlighted even though their use of bank credit lines is holding steady at fifty percent due to delinquency-impact fears and knowledge gaps regarding alternative funding sources.
- Cash-equivalent funding instruments, stablecoins, and mutual funds continue to have acute run risk.
- CCP liquidity risk is low, but elevated at life insurers. CCPs were stable through a bout of large variation-margin calls in March, but activity is concentrated at large clearing members and it remains unclear how CCPs would function if any such member faltered.
- Despite deposit outflows, banks and especially GSIBs are sufficiently liquid, with reliance on short-term wholesale funds dropping since the November report even after taking March into account. Data in the report suggest that many banks swapped market funding for FHLB and FRB-window borrowings. The report also contains a strong defense of the Fed's emergency facilities without describing how funding was also provided to the FDIC.

**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

**© 2023. Federal Financial Analytics, Inc. All rights reserved.**