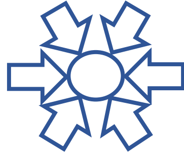

FedFin Client Report

Monday, October 23, 2023

FedFin Assessment: FRB Tries to Link Stability Conclusions to Regulatory Objectives

Client Report: SYSTEMIC97

Executive Summary

As promised, this in-depth report assesses Friday's semiannual financial-stability report from the Federal Reserve. As in its most recent reports, the Fed again eschews any clear conclusion about financial stability even as it observes that some risks are hard to quantify and thus may be overlooked. Prior reports of "moderate" risk were shortly followed as in 2020 with considerable systemic challenge, leading the Fed thereafter and in this report to limit itself principally to quantification of emerging issues with few conclusions and, other than with regard to banks, no direct regulatory recommendations. Where the Fed points to significant systemic challenges, it does so only by citing third-party survey results. Here, the report raises fears about inflation/monetary tightening, CRE, banking stress, geopolitical risk, Chinese-market fragility, and market-liquidity stress. In addition, the Fed continues to say only that it is assessing climate risk. The report does reiterate that banks are generally sound, liquid, and capital resilient. However, it now observes that the regional banks subject to pending regulatory rewrites show significant vulnerabilities. Much else repeats the May report (see *Client Report* **SYSTEMIC96**) with regard to concerns such as NBFIs, insurance-company liquidity, and hedge-fund leverage. However, the Fed now looks more closely at secondary markets, specifically stating that securitization SPVs may be prone to sudden drawdowns that, if correlated, could threaten market liquidity.

Analysis

Conclusions with policy impact include:

- Asset valuations increased to a "notable level" since the May report, but the Fed's analysis does not suggest the express interventions the Bank of England has recently undertaken to address this.
- Treasury-market liquidity "remains strained" and liquidity "may be less resilient than usual."
- Business- and household- vulnerability remains moderate.
- Gross non-financial corporate leverage remains high, with net leverage edging up with "signs of vulnerability" evident across weaker corporate-debt sectors.
- The overall banking system is sound, but some banks are experiencing sharp market-capitalization declines. Bank regulatory risk-based and CET1 capital increased over the past

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six months and is "solid," but tangible common equity ratios have declined at GSIBs and large regionals have problematic capital and liquidity resilience. Bank vulnerability to future credit loss is "moderate" despite CRE exposures. Regionals have also not yet ensured ample liquidity in the absence of the LCR and deposit outflow.

- Hedge-fund leverage is "somewhat elevated," a less alarming conclusion than suggested in the report's overview. However, high leverage is said to be the result of low Treasury-market hair-cuts, perhaps hinting at proposals for higher mandatory haircuts noted in last week's press reports.
- Bank lending to NBFIs remains high, signaling undue NBFI leverage. Growth is most pronounced in SPVs and securitization entities (25 percent YoY growth). Line use and delinquencies are low, but the Fed fears sudden, correlated drawdowns that would be material compared to large-bank HQLAs, leading to liquidity stress. Scant data on NBFI nonbank borrowing makes it possible that strain could be still more acute.
- Prime MMFs and other cash-flow vehicles remain vulnerable to redemption risk, with these funds and government MMFs also vulnerable to sharp interest rate increases given NAVs.
- Although stablecoin market capitalization has declined, it remains vulnerable to run risk.

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