FedFin Client Report

Monday, December 18, 2023

FedFin Assessment: FSOC Worries A Lot, Watches, Waits

Client Report: FSOC29

Executive Summary

This year's FSOC report trods much old ground with two exceptions. The first pertains to a new focus on artificial intelligence, machine learning, and new, generative technologies. That said, the report does little beyond highlight this risk and include it among all the others federal agencies are told to monitor. Private credit now also alarms FSOC, with insurance company investment in this sector of particular systemic concern in concert with the sectors' CRE and junk-bond exposures, offshore reinsurance, and PE ownership. As detailed in this report, banks are found to be resilient and have ample capital even as the report supports consideration of pending regulatory revisions. Banking agencies are also asked to monitor uninsured-deposit levels and assess run-risk in light of social media and other accelerants. In sharp contrast to more alarmist statements in the past and extensive Treasury reports (see *Client Report* **CRYPTO32**), this year's report downplays cryptoasset risk because federal regulators are said to have taken steps to contain it. The report also reiterates FSOC's continuing focus on cyber and climate risk, with the closed session preceding the meeting considering a framework being developed by the OCC to measure and monitor financial risks and bank exposures. Agencies are also encouraged to pursue comparable, "decision-useful" climate disclosures. The LIBOR transition is considered a success and no longer poses a systemic risk.

Analysis

The report includes an assessment of the mid-March failures, concluding that these demonstrated the systemic risk presented by non-GSIBs because of run risk empowered by new technology and social media. Regulators are asked to pursue deposit-insurance reform even though FSOC takes no stand on what they should entail. Even so, the report reiterates that banks have "sound" levels of capital, "healthy" profitability, and "ample" liquidity buffers. GSIBs are also found to have maintained capital at levels seen over the past decade, but these and other banks are said to face continuing threats as rates rise and, for regional and community banks, CRE. NBFI risk is found to warrant monitoring.

As highlighted by Secretary Yellen, SEC Chair Gensler, and others at FSOC's December 14 meeting, the report for the first time flags AI as an emerging systemic risk especially as generative AI advances. Explainability challenges are said to make it difficult to assess AI models and their output, with large data-set reliance and third-party vendors creating operational risk related to data control, privacy, and cyber-security. Despite this, it seems likely that AI will only be the focus of monitoring, not of any specific interventions.

As noted, insurance companies also are a top concern due in part to FSOC's new focus on private credit. The Council supports FIO and NAIC work to address this risk and urges continuing attention to systemic challenges.

Indeed, FSOC's recommendations are principally for continuing monitoring not only of AI and private credit, but also of long-standing risks. These include:

- CRE, with supervisors, financial institutions, and investors told to closely monitor risk trends and concentrations with an eye to stress-testing, adequate reserving, underwriting, and contingency planning;
- Residential real estate, where concerns have risen with FSOC thus worrying about loan losses and urging federal and state supervisors to collaborate and share information with regard to loan and servicing risk. FSOC supports recent FHFA, Ginnie Mae, and state regulators' attempts to strengthen nonbank mortgage-servicer oversight, urging unspecified "additional steps";
- NBFIs, with the focus here on the potential for sharp hikes in defaults to strain investment funds and disrupt bond markets along with cascading effects across other financial markets. FSOC thus recommends monitoring of NBFI leverage, asset valuation, and the potential effect of sustained high rates. FSOC continues to support the SEC's MMF rule (see FSM Report **MMF20**), planning continued monitoring and urging work to enhance stability in other sectors that, while unnamed, are presumably most importantly comprised of OEFs;
- Bilateral OTC repos, with work pressed to reduce counterparty risk via higher haircuts;
- CCPs, with FSOC supporting Fed, CFTC, and SEC work to improve the governance of CCPs designated as FMUs, but urging more focus on stress testing and resolvability. The agencies are also asked to consider clearing-member liquidity and risky inter-connectivity; and
- Third-party vendors, with the Council here interestingly mentioning conference-call providers as a particular concern along with core processors and others it and the banking agencies have long identified. FSOC also supports ongoing work on cloud-service providers.

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