



FedFin Client Report

Monday, April 22, 2024

Fed Systemic-Risk Assessment: Some Worries, No Troubles

Client Report: SYSTEMIC99

Executive Summary

The latest Federal Reserve financial-stability [assessment](#) continues the Fed's practice of detailing vulnerabilities without drawing bottom-line conclusions; the Board once did so, but ceased this practice after opining that the financial system's risk was "moderate" shortly before the 2020 crash. The Board's report now also says that it assesses vulnerabilities, not the likelihood of near-term shock. Survey respondents do make this assessment, with this report showing a striking increase in concerns about policy uncertainty in light of continuing inflation and the higher-for-longer rate outlook. The Fed continues to fear vulnerabilities due to historic levels of hedge-fund leverage, life-insurance illiquidity, and MMF redemption risk. The Fed seems to be less concerned about these risks than the IMF's recent financial-stability [assessment](#), although new big-bank stress tests now include an exploratory scenario related to hedge funds ([see Client Report STRESS32](#)). The report does not voice the concerns about private credit laid out in recent [Fed research](#) or by the [IMF](#).

The banking system is found overall to be strong despite pockets of risk at banks with high levels of unrealized losses and/or uninsured deposits. The report also includes a box detailing how the [Bank Term Funding Program](#) was, it says, successfully used without making clear how this pertains to future financial stability. The Fed also notes record levels of household debt but concludes that leverage is manageable due to high levels also of home equity; we would note that, while this may be true in the aggregate, lower-income households with the greatest debt burdens also often have little to no home equity. As a result, sectoral challenges to financial stability may result if credit-risk challenges in the subprime arena challenge some financial institutions or migrate to near-prime markets. As the Fed does note, a sharp macroeconomic downturn could thus be challenging.

Analysis

The Fed's overall risk conclusions are that, since last October:

- asset-valuation vulnerabilities increased;
- household and corporate leverage remains sound, despite data showing significant increases in household debt burden (which the Fed believes is offset by home equity). The Fed does note growing worries related to corporate-bond default risk;

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- the banking system remains sound and resilient, although some banks face sizeable unrealized losses or high CRE exposures. Hedge-fund leverage is at a historic high with life-insurance leverage at median range as credit and liquidity risk grew. Broker-dealer leverage remains near historic lows; and
- liquidity at most domestic banks is “ample,” although some have unduly high levels of uninsured deposits asset-valuation declines, and CRE exposures. Other short-term funding markets remain vulnerable, with the Fed continuing its concerns over prime and cash-exempt MMFs, bond funds, cash-management vehicles, and stablecoins.

Survey respondents highlighted:

- the risk of higher for longer and resulting policy uncertainty (an issue raised far more in this survey than late last year); and
- somewhat reduced levels of concern about banking-system vulnerability. However, respondents remain concerned about general financial instability and fiscal-debt sustainability.