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Regulatory Alert

Financial Services Regulatory Insight Center

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Federal Reserve publishes first Financial Stability Report

Key points

- The Federal Reserve's Financial Stability Report and its Supervision and Regulation Report, both released in November 2018, are intended to "promote public understanding and increase transparency and accountability for the Federal Reserve." The Federal Reserve plans to regularly publish these reports.
- The Federal Reserve has developed a framework for monitoring and assessing vulnerabilities to U.S. financial stability considering the extent to which asset values, business and household debt burden, financial institution leverage, and funding risks vary from historical norms. There is not yet a generally accepted standard to assess when these vulnerabilities will pose a serious stability risk.
- Additional risks posed by domestic or international developments that could trigger distress in the U.S. financial system are also monitored under the framework.

Following the publication of its inaugural Supervision and Regulation Report, the Federal Reserve has now published its first Financial Stability Report. This new report summarizes the agency's framework for monitoring and assessing the stability of the U.S. financial system. The framework focuses on vulnerabilities, or features of the financial system that can amplify sudden changes to financial and economic conditions, referred to as triggers or shocks. At present, the Federal Reserve's overall assessment is that the U.S. financial system is far more resilient than it was before the crisis due in large part to post-crisis reforms, including those in the areas of capital and liquidity, stress-testing, resolution and recovery planning, money market funds, and derivatives.

The framework covers four broad categories of vulnerabilities. Federal Reserve Chair Jerome Powell stated there is not yet any generally accepted standard for assessing the level at which these vulnerabilities begin to pose serious stability risks so cases in which the vulnerabilities "rise well beyond historical norms" are highlighted in the report. He added that, in his opinion, "while risks are above normal in some areas and below normal in others, overall financial stability vulnerabilities are at a moderate level."

Areas of potential vulnerability

- **Asset valuation pressures:** As detailed in the report, asset valuations appear elevated relative to historical ranges, suggesting investors have a heightened risk tolerance. The report also notes low yields and term premiums for Treasury markets, low spreads on high-yield corporate bonds and leveraged loans, and high equity prices relative to forecast earnings. Additionally, prices for commercial real estate, farmland, and housing remain relatively high.
- **Borrowing by businesses and households:** The report states that while household borrowing is low-to-moderate and has risen

roughly in line with incomes, business debt is historically high relative to GDP and there are signs of deteriorating credit standards for business loans. In the past year, firms with high leverage and interest burdens have increased their debt loads the most; the issuance of high-yield bonds and leveraged loans has increased. Credit risk from mortgage debt appears to be low though some vulnerabilities have been identified in early payment credit cards and auto loan delinquencies.

- **Leverage in the financial sector:** The Federal Reserve finds that overall leverage in the financial sector is low, in part because of regulatory reforms. The nation's largest banks are strongly capitalized, and broker-dealers and insurance companies have strengthened their post-crisis financial positions. Some indicators suggest that leverage in nonbank financial firms, and specifically hedge funds, is increasing.
- **Funding risks:** Funding risks are low compared to pre-crisis levels due in part to liquidity reforms. Banks hold more liquid assets and rely less on funding sources that proved susceptible to runs. However, the report calls out increases in the size of corporate debt mutual funds, life insurers' holdings of less-liquid assets, and, in particular, the size, concentration, and highly interconnected nature of central counterparties (CCPs).

The Federal Reserve notes that it is working to develop resiliency expectations and measures for risks associated with cybersecurity and crypto-assets.

Near-term risks

In addition to the four vulnerabilities, the monitoring framework includes an assessment of developments in domestic and international markets that the Federal Reserve believes could serve as triggers to distress in the U.S. financial system. The current report outlines potential near-term risks related to the Brexit negotiations, U.S. trade negotiations, emerging market economies, geopolitical uncertainties, and rising interest rates.

Click here to download the Regulatory Alert on the Federal Reserve's Supervision and Regulation Report.

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