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Federal Reserve Issues Latest Financial Stability Report

By Daniel Meade
Partner | Financial Regulation

At the end of last week, the Federal Reserve Board ("FRB") issued its semi-annual Financial Stability Report.

In a statement issued with the report, FRB Vice Chair Lael Brainard stated that over the past six months, "household and business indebtedness has remained generally stable, and on aggregate households and businesses have maintained the ability to cover debt servicing, despite rising interest rates." She also noted that "[t]oday's environment of rapid synchronous global monetary policy tightening, elevated inflation, and high uncertainty associated with the pandemic and the war raises the risk that a shock could lead to the amplification of vulnerabilities, for instance due to strained liquidity in core financial markets or hidden leverage."

The Report notes that the FRB's monitoring framework "distinguishes between shocks to, and vulnerabilities of, the financial system," and "focuses primarily on assessing vulnerabilities, with an emphasis on four broad categories and how those categories might interact to amplify stress in the financial system." The four categories of vulnerabilities are (1) valuation pressures, (2) borrowing by businesses and households, (3) leverage within the financial sector, and (4) funding risks. The overview of the Report notes that since the May report was released, "the economic outlook has weakened and uncertainty about the outlook has remained elevated, noting that "[i]nflation remains unacceptably high in the United States and is also elevated in many other countries."

Related to the funding risk vulnerability (and perhaps showing some prescience to our lead story on FTX this week), the Report noted that stable coins remained vulnerable to runs. The Report included a highlighted discussion of digital assets and financial stability noting trouble and volatility in the crypto market in the spring of this year. That discussion noted that the "[t]he turmoil in the digital asset ecosystem did not have notable effects on the traditional financial system because the digital assets ecosystem does not provide significant financial services and its interconnections with the broader financial system are limited." However, the report noted that as digital assets grow, so too will the risks to financial stability, and cited the October FSOC Report on Digital Asset Financial Stability Risks and Regulation in addressing those risks and regulatory gaps.

The Report identified several near-term risks that “could be amplified” through the four financial vulnerabilities, including high inflation, geopolitical risks (noting Russia’s invasion of Ukraine), market fragilities, and possible shocks caused by a cyber event.