OFFICE OF FINANCIAL RESEARCH

FINANCIAL RESEARCH ADVISORY COMMITTEE

TOPIC: Risks from the nonbanking sector

SUMMARY

The OFR is requesting that the Financial Research Advisory Committee discuss how the OFR should approach assessing risks from nonbank financial institutions.

BACKGROUND

Nonbank financial institutions are major participants in the financial sector, and as a result, assessing their resilience is key to safeguarding financial stability. In the current economic and financial environment, these institutions face uncertainty from rising inflation, tightening credit conditions, and an evolving geopolitical landscape, with varying effects across the spectrum of institutions within the sector.

For example, under elevated redemption conditions, open-end funds have the potential to create risks to financial stability. Such shocks can have broader financial and economic implications, due to the large size and intrinsic link to financial markets though money market, mutual, and exchange-traded bond funds. Given that these open-end funds lack a guaranteed backstop and that many have a structural liquidity mismatch, they may be vulnerable to runs that reduce credit supply and amplify stress.

Additionally, other classes of private funds—such as hedge funds, which have redemption restrictions—are likely to face further pressures under the current environment. Such pressures include inflation, increased interest rates, and funding limits, which create sudden deleveraging cycles.

In the insurance sector, property and casualty insurers are attempting to raise premiums to restore profitability, but this will be a long-term process. Profitability is likely to remain depressed for an extended period because the costs and availability of higher-risk property coverage are becoming increasingly challenging for firms to support. For instance, in 2022, Florida changed its insurance laws twice to help stabilize its market. Additionally, the tightening of the reinsurance market has disrupted the insurance industry’s risk management efforts.

QUESTIONS

1. Are there any activities or classes of financial institutions that pose a greater risk to financial stability and should be areas where OFR should initially focus its monitoring activities?

2. Should OFR consider thresholds, such as size or concentration, for identifying and assessing financial institutions engaging in various market activities?

3. What are the potential risks posed by private equity firms or the emergence of digital assets?