Exploratory Analysis of Risks to the Banking System

Summary of Analysis Parameters

February 2025

The Federal Reserve is conducting an exploratory analysis as a companion to the 2025 supervisory stress test. The analysis is distinct from the supervisory stress test and will complement it by providing aggregate banking system results against different economic and financial conditions. Taken together, the supervisory stress test and exploratory analysis will provide insight into the resiliency of the U.S. banking system. The conditions for the exploratory analysis are not Federal Reserve forecasts. The exploratory analysis will not affect large bank capital requirements.

The 2025 exploratory analysis examines certain risks posed to banks by nonbank financial institutions (NBFIs). U.S. bank exposures to NBFIs have grown rapidly over the past five years, and banks' credit commitments to NBFIs reached about $2.1 trillion in the third quarter of 2024 at large banks.[1] This growth poses risks to banks, as certain NBFIs operate with high leverage and are dependent on funding from the banking sector. The proposed exploratory analysis will contain two parts:

1. Credit and liquidity shocks in the NBFI sector, during a severe global recession; and
2. A market shock featuring a sudden dislocation to financial markets resulting from expectations of reduced global economic activity and higher inflation expectations. This distress in equity markets causes the unexpected defaults of the subject bank's five largest equity hedge fund counterparties.

The exploratory analysis can inform supervisory analysis and deepen the Federal Reserve's understanding of the resilience of the banking system. The projected paths of the variables used in this analysis are available on the Board's public website.[2] Aggregate results for the exploratory analysis will be published in June 2025.

Credit and Liquidity Shock to the NBFI Sector

The first element of exploratory analysis examines adverse conditions that banks may experience under a shock to NBFI borrowers. To test the risks of shocks to NBFI borrowers during a severe

[1] See figure 3.15 in Board of Governors of the Federal Reserve System, *Financial Stability Report* (Washington: Board of Governors, November 2024), https://www.federalreserve.gov/publications/November-2024-Leverage-in-the-Financial-Sector.htm.

[2] See the Federal Reserve Board's website at https://www.federalreserve.gov/supervisionreg/dfa-stress-tests-2025.htm.

global recession, the set of macroeconomic conditions considered is the same as the set of macroeconomic conditions in the severely adverse scenario.[3]

The exploratory analysis considers additional credit and liquidity stress to certain categories of NBFIs:

1. Rapid deterioration in the credit quality of assets held by highly leveraged NBFIs that extend credit, leading to downgrades in their own credit ratings;[4] and
2. NBFIs, which historically rely more heavily on the banks' lines of credit in times of stress, draw more heavily on their lines of credit with banks.

Exploratory Market Shock

The second element of the exploratory analysis is aimed at understanding the vulnerability of the largest banks to an exploratory market shock.[5] Exposures to market risks at the largest banks are dynamic in terms of direction and can vary across firms. Using an exploratory market shock helps the Federal Reserve understand the implications of a wider range of vulnerabilities.

The exploratory market shock is characterized by a sudden dislocation to financial markets stemming from expectations of reduced global economic activity and higher inflation expectations. The U.S. dollar appreciates against other major currencies. Increases in interest rates and commodity prices suggest risks for persistent inflation. Short-term Treasury security yields rise sharply, while long-term yields increase to a lesser extent. An increase in anticipated defaults leads to a widening in credit spreads. Equity prices decline from the expected fall in economic activity, while volatility rises from heightened market uncertainty.[6] This increase in volatility leads to certain equity positions severely underperforming market indexes. Hedge funds, unable to meet margin calls, are forced to liquidate equity positions at a loss; the five hedge funds with the largest counterparty exposures for each bank are assumed to fail.

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[3] This severe global recession is identical to the supervisory severely adverse scenario in the 2025 stress test. For more information, refer to the 2025 Stress Test Scenarios.

[4] These subsectors are special purpose entities, collateralized loan obligations, and asset-backed securities; broker-dealers; private equity, business development companies, and credit funds; real estate investment trusts; and other financial vehicles.

[5] The exploratory market shocks are only applicable to the eight U.S. global systemically important banks and are applied to positions held by the banks as of October 11, 2024.

[6] The shock to U.S. equities is –20 percent. To represent the potential for further stress in concentrated positions, concentrated long single-name equity positions will receive a shock of –35 percent, while concentrated short single-name equity positions will receive a shock of –10 percent.