EXECUTIVE SUMMARY

The OFR 2023 Annual Report discusses the Office's assessment of risks associated with the U.S. financial system and reviews the performance of the OFR. We summarize the report's findings in this section.

Financial Stability Risks to the U.S. Economy

Financial stability risks have increased since last year's report and remain elevated in 2023. Multiple indicators signal an upcoming economic slowdown—potentially magnified by persistent inflation, ongoing geopolitical risks, and global conflicts. The strength of the labor markets has offset the probability of a recession in the United States in the near term, but the persistence of higher interest rates has created more challenging financial conditions and raised the prospect of a recession in the medium term (see **U.S. Economy**).

To manage core inflation, the Federal Reserve and other central banks are intent on keeping policy rates higher for longer. This policy posture has the effect of increasing borrowing costs for both companies and households, potentially dampening economic growth. Higher rates and the Federal Reserve's quantitative tightening have been accompanied by volatility in the bond and equity markets. U.S. federal government deficits and bond yields have increased, causing investors to focus on the federal government's ability to finance its spending needs. Treasury yields have risen sharply for 2-, 5-, and 10-year Treasuries, eclipsing 4.5% for the first time since 2007 (see **Treasury Market**).

After the fiscal and monetary stimulus programs associated with the COVID-19 pandemic ended in 2021, the Federal Reserve began monetary tightening in 2022. That reversal in policy may have caused turbulence in the banking, funding, and real estate markets in 2023. Several regional banking institutions failed or self-liquidated in the first half of 2023—largely due to an influx of deposits during the pandemic, followed by the banks' failure to manage interest rate risks as financial conditions reversed. Many banks' fixed-income securities portfolios showed large unrealized losses due to rising rates, and banks that had to sell securities to repay depositors sold those securities at a loss. In some cases, those losses contributed to the demise of certain banks (see **Banks**).

Banks experienced a large-scale outflow of deposits, with much of the funds going into MMFs and other investment vehicles. In contrast, the asset management industry has become increasingly concentrated. Assets under management for the industry ranged between $78 - $114 trillion, up from approximately $24 trillion in 2008 (see **Short-term Funding** and **Asset Management**). Assets in MMFs totaled $6.16 trillion at the end of September.

Credit risks have built up in the CRE sector as borrowing rates have increased, pushing valuations significantly lower. Of particular concern is the decline in valuations of office space, as vacancy rates have increased following the rise of the WFH trend. While CRE loan default rates continue to be relatively low, they are expected to rise significantly as leases come up for renewal. Regional, smaller, and community banks are more exposed to CRE lending and, therefore, more vulnerable to increasing default rates than the largest banks (see **Commercial Real Estate**).

Banks also provide substantial lending to small and medium-sized companies, and tighter credit conditions as banks curtail lending can potentially destabilize such companies with weaker balance sheets. Similar trends exist in the leveraged loan markets, where borrowing costs have risen sharply during a period of weaker earnings growth. This combination has weakened interest coverage ratios and increased the risk of default (see **Nonfinancial Corporate Credit**).

The inventory of homes for sale remains tight, pushing prices higher, while mortgage rates have reached their highest levels in 23 years. The confluence of these two factors has eroded home affordability (see **Residential Real Estate**). As labor markets remain tight, consumer spending and liquidity remain resilient, but consumer debt has risen while household savings have declined. This is particularly true for households with weaker credit. Delinquencies for certain segments have reverted to prepandemic levels, though they remain within historically low ranges overall (see **Household Credit**).

The property insurance sector is facing unprecedented stress that is expected to continue for an extended period. While P&C insurers have benefited from increased investment income from rising interest rates, this benefit has often been offset by rapidly rising claims costs, especially in property-exposed lines such as homeowners' insurance. While insurers may have been able to pass some of their increased costs on to consumers, some insurers have instead opted to exit certain states more prone to natural catastrophes (see **Insurance**).

Hedge funds' short Treasury futures positions have grown considerably since April 2022. This is consistent with (1) the re-emergence of the Treasury cash-futures basis trade or (2) funds placing large directional bets that Treasury yields will continue to rise. While it is difficult to separate the drivers of the growth in futures positions, both strategies can result in large losses that stem from and exacerbate Treasury market instability. In March 2023, the level of Treasury market implied volatility exceeded those seen in March 2020—when a flight to cash led to the unwinding of positions to meet margin payments, which put more downward pressure on Treasury prices, thus increasing Treasury yields (see **Hedge Funds**).

Risks continue to evolve, particularly in digital assets and cybersecurity. Over the past year, turmoil in the digital assets markets has exposed and even increased the high level of interconnectedness between digital asset firms and traditional markets, highlighting the impact of digital assets on financial institutions. Meanwhile, financial institutions have faced cybersecurity threats from financially motivated groups. The percentage of organizations affected by ransomware has risen from 79% to 87% in 2023. This surge in ransomware attacks has resulted in the highest proportion of data breaches in the financial services industry since 2018 (see **Digital Assets** and **Cybersecurity Risks in Financial Institutions**).

The U.S. economy remains among the most robust relative to the rest of the world. On the other hand, European economies are bearing the brunt of the effects of Russia's war against Ukraine, with the German economy officially entering a recession in 2023. Other large European economies are also beginning to falter as their consumers see a decline in economic growth coupled with persistently high inflation. A protracted conflict in Ukraine may increasingly cause harmful effects on the economies and populations of Europe, raising the risks to U.S. financial stability. Emerging markets grapple with high commodity prices, a strong dollar, and unsustainable debt burdens. Tensions between the U.S. and China, plus China's economic slowdown and deepening debt problems, also contribute to global economic uncertainty. In September, the yuan depreciated as low as 7.3415 per dollar, its weakest close since December 2007. A rapid depreciation of the yuan can cause large disruptions in U.S. markets, given the large dollar reserves held by China's central bank and China's large holdings of U.S. debt (see **Foreign Economies**).

Status of the Office of Financial Research

During FY 2023, the OFR launched several initiatives to advance the financial stability research, analysis, data collection, data-sharing, and monitoring capabilities of the OFR and the Council and its member agencies.

Following the OFR's successful NCCBR pilot in FY 2022, we issued an NPRM in January 2023 to further our efforts to improve transparency and fill a data gap in the U.S. repo market that was highlighted by the March 2020 Treasury market disruptions.

After the NCCBR pilot, the OFR began building the DCU to facilitate the collection of any type or volume of data directly from external entities under OFR rules, voluntary data pilots, and surveys, as well as in other circumstances. In 2023, the OFR completed the DCU's initial build and testing. The DCU is expected to go into production in early 2024, and the Office may use it for the NCCBR collection.

We made additional efforts to improve the OFR's data infrastructure by updating and reformatting the IDI based on inputs and edits received by Council member agencies.

In July 2023, the OFR launched JADE—a secure, cloud-based platform designed to provide Council member agencies with access to analysis-ready data, analytical software, and high-performance computing. JADE will allow Council member agencies to jointly analyze financial stability risks and enable collaborative, interdisciplinary research on financial stability.

The OFR enhanced certain of our monitors. We updated the FSI to prepare for the transition from USD LIBOR to the SOFR. The Office also upgraded the BSRM's data-sourcing process to improve efficiency.

The OFR focused on enhancing its data standards and the FIRD. Through the NITRD program, the Office was one of several agencies to partner with the White House Office of Science and Technology Policy and the NSF to develop the National Standards Strategy for Critical and Emerging Technologies, which was released in May 2023. In addition, we completed the integration of the ACTUS standard with the FIRD.

The OFR continued to engage our leadership and staff and use our Integrated Planning approach to strategize the work needed to advance our mission and align resources to achieve our goals. The Office used a portion of our funding from the Financial Research Fund to expand our in-house data collection capabilities and operationalize JADE.

We also made progress on our workforce plan and grew our team by 12%, allowing us to close gaps in subject matter expertise and fill critical leadership positions. To address workforce development and training gaps, the Office invested in employee learning and development and enterprise-wide learning opportunities, such as data analytics training and change management.

The OFR made significant efforts to modernize our technology by optimizing our cloud environments, investing in cybersecurity services to ensure the protection of our data, and implementing Zero Trust cybersecurity capabilities. We developed a completely cloud-based environment for JADE using Zero Trust architecture capabilities.