TIMOTHY CUDDIHY

Managing Director,
The Depository Trust & Clearing Corporation (DTCC)

Balancing act: maximizing potential, minimizing risk of NBFIs

Non-bank financial institutions (NBFIs) exist somewhat outside the traditional banking system, but they can play an important market intermediation role. NBFIs support markets, as they can broaden the availability of investment options, enabling risk diversification and financial innovation. These types of firms are often more nimble than traditional avenues and can provide a faster source of credit and liquidity capacity.

Because of these key benefits, there has been significant growth in this sector over the past decade as firms navigate environmental factors including changes in bank regulation; capital and liquidity constraints in traditional financing; strong capital flows into alternative venues that seek higher returns; technology advancements including digital assets; and better addressing areas of the financial system that are under-served.
In fact, two market events - the global financial crisis and the volatility spurred by the COVID-19 pandemic in 2020 - reinforced just how systemically important NBFIs have become. After all, NBFIs form an important part of the bank credit intermediation chain, connecting with counterparties around the world. But with these connections and the increasingly prominent role of NBFIs can also elevate risk.

Managing Risks in a Growing Segment

One area of growing risk is around the connections that exist between NBFIs and other firms. Interconnectedness risk has become a growing area of focus within the industry, as firms look more closely at the NBFI activity, connections and potential contagion risks that exist between organizations. Policymakers are also exploring this important area as they work to identify how to maximize the benefits of NBFIs while minimizing systemic risks. At the same time, NBFIs have different requirements for liquidity and capital buffers than banks. In the U.S., NBFIs may build up leverage outside the regulated banking system, which can amplify shocks during market or firm-specific dislocations. The key question becomes: how can we further protect this growing segment of the market, as they deliver increasingly critical services to the industry? We believe the answer lies in the increased resiliency and transparency.

The Value of CCPs

Introducing central counterparties (CCPs) and trade repositories – proven, best practice utilities – to the NBFI sector could deliver the same major benefits that they bring to traditional financial sectors, including transparency, risk mitigation, and standardization. Both central counterparties and trade repositories play a role in aggregating trade and counterparty information. While central counterparties are focused on protecting market stability and maximizing value for the industry through standardization and efforts to reduce risk, trade reporting enables regulators to assess traditional banking broadly, including concentration exposures, for example in the OTC derivatives space.

Most recently, CCPs played key roles in helping the industry navigate the volumes and volatility as a result of the pandemic, with many key stakeholders across the industry stating that market stability was enhanced by central clearing. Given the increasingly systemic importance of CCPs, future international policy will likely focus on the evolving role of central clearing in order to address risks that fall squarely in the NBFI sector, including risks to financial stability, the interactions between banks and non-banks, and the resilience of NBFIs.

The Way Forward

While NBFIs offer major benefits to the industry, including their ability to provide liquidity, they also come with their own set of unique challenges and risks that could have far-reaching impacts. The use of an intermediary such as a central clearing counterparty and services like trade reporting utilities could provide the standardization, transparency and risk-reduction benefits that are greatly needed in the NBFI sector, while better supporting the industry's growth and enabling it to continue reaping the benefits of all it has to offer.