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How regulators can address financial stability concerns in non-bank financial intermediation (NBFI)

Despite the scale of the Covid-19 pandemic and the depth of the economic shock it has triggered, financial markets have proved largely resilient to significant volatility and unprecedented operational strains. Market participants were able to switch on business continuity plans and transition to remote working, while critical financial market infrastructures were able to withstand all-time highs in trading activity. Nonetheless, the period of extreme market volatility in the Spring of last year did see dislocations in some parts of the market, and these need to be addressed.

The response to the Covid market stress has been a global effort, spearheaded by the Financial Stability Board (FSB) and coordinated across other bodies including IOSCO and the IAIS. Working with our counterparts in the UK, the EU and globally, it became quickly apparent that the risks we had seen were complex and intertwined, and that developing an adequate policy response would not be straightforward. The FSB's 'holistic review of the March market turmoil', presented to the G20 in October 2020 is the outcome of these initial deliberations. It sets out an ambitious roadmap for analysis and assessment, both of specific markets or actors, as well as the links that connect them. Considering global regulatory issues in a joined-up manner such as this is precisely what the FSB was established to do after the last financial crisis.

A key lesson learned from this crisis must therefore be to reaffirm the value of a global regulatory architecture that reflects the globally interconnected nature of financial markets. While a holistic approach is more complex - and can appear slow from the outside - the consensus remains that a piecemeal approach simply won't work.

This is particularly the case when considering vulnerabilities in non-bank financial intermediation (NBFI). This has grown markedly over recent years and now shoulders much of the risk previously held by banks, prior to global banking reforms in the wake of the 2008 crisis.

To consider the resilience of NBFI as a whole, therefore, some of the key areas we are working on at the FSB and other bodies are:

- We are looking closely at Money market funds (MMFs). Some funds experienced significant liquidity pressures over the Spring, in particular prime MMFs in the United States. Given the key role MMFs play in funding and managing the cash of corporates across the real economy, our priority is to ensure that liquidity risk borne by these funds is both well managed and adequately understood by investors.
- We are working to shed light on the behaviour of the broker-dealers active in short term funding markets, what factors may have constrained their ability or willingness to intermediate, and the knock-on effects of this for MMFs.
- We want to further deepen our understanding of the redemption pressures and liquidity risk management practices in open-ended funds. Discussions about liquidity mismatch, and the tools to manage this, pre-date the COVID crisis, but have found a new urgency in its wake. In the UK, we have already begun work on potential rule changes for property funds, which represent the largest portion of funds (by Assets under Management) that suspended trading during March 2020.
- Liquidity in corporate bond markets over the course of the market stress, and in the wake of central bank interventions, is an important consideration. We want to understand trends in the liquidity, structure, and resilience of these markets as a core part of well-functioning capital markets.
- Finally, in a joint effort across relevant global standard setting bodies, we are analysing margining practices and the extent to which elevated margin calls in cleared and Over-the-Counter markets may in turn have transmitted liquidity pressures to the rest of the system.

All of this work will allow us to address the fundamental questions of systemic resilience, and if we see possible vulnerabilities, undertake reforms where needed. We neither can, nor should, seek to eliminate risk entirely from the financial system. Neither should we take steps which shift risk from one part of the system to another without due consideration of the consequences, in particular on investors and the critical role that non-bank financial actors play in funding the real economy and the recovery from this crisis.

The financial system has proved to be a reliable and resilient channel for funding throughout the Covid-19 pandemic to date, and we must ensure it remains able to be so in the future.