FSB FINANCIAL STABILITY BOARD

As prepared for delivery

Potential Financial Headwinds – Why the FSB is focused on non-bank financial intermediation

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Keynote speech by John Schindler, Secretary General, Financial Stability Board[1]

Introduction

Good afternoon everyone. It's great to be here. Let me start by thanking the organisers for the invitation to come and speak here today. I am honoured to have been asked.

I think it is an interesting time to be working on financial stability, as so many things have been going on, and we are learning more every day about the resilience of our financial system. Perhaps things are not as exciting right now as they were in March, but I don't think we can let our guard down. I'm reminded of a time about 15 years ago, when I was seconded to the US Treasury Department. I started there in April 2008. On my first day there, I was in the office of the Under Secretary for International Affairs, who I was reporting to. This was just a few weeks after Bear Stearns demise. He welcomed me aboard and then he apologised and said something like – I'm sorry you missed all of the excitement, but we'll find something interesting for you to work on. Of course, about three months later Lehman Brothers failed and I and everyone there spent several months working nearly non-stop on a variety of aspects of that crisis and the response. I'm not suggesting that we are on the verge of another Lehman, but I hope we aren't complacent since things are relatively calm.

The topic of this conference is financial headwinds, and I gave some thought to what to speak about, because just about everything the Financial Stability Board (FSB) works on could be described as a financial headwind – otherwise we wouldn't be working on it. One of our top priorities at the FSB is crypto-assets, and just a couple of weeks ago we published a set of high-level recommendations that help establish a global regulatory framework for crypto-assets and stablecoins. This is a big step forward in making the financial system safer. However, I think

[1] The views expressed in these remarks are those of the speaker and do not necessarily reflect those of the FSB or its members.

crypto-assets are not yet integrated enough into the financial system that I could argue they represent a significant headwind. Still, I couldn't give a speech without at least putting in a quick plug for the recommendations that have gone out.

Another possible choice was the banking turmoil in the United States and Switzerland that took place in March. Problems in the banking sector are very easy to view as headwinds, and there is little doubt that some of the problems we saw were linked to rapid monetary tightening in response to inflation. So that would fit very much with the theme of this conference. The regulatory reforms put in place after the 2008 global financial crisis provided some buffer against the turmoil. Banks had stronger capital and liquidity positions, and enhanced resolution planning and stronger cross-border regulatory and supervisory cooperation meant that authorities in individual jurisdictions were able to act swiftly and that central banks were able to coordinate to increase the availability of liquidity across borders. I don't doubt that, without the post-global financial crisis reforms, the stress faced by individual banks would have led to broader contagion within the financial system than what we experienced.

Still, the turmoil highlighted a number of issues that merit further attention, like interest rate risk, deposit dynamics, and the effective implementation of the international resolution framework. The FSB and the Basel Committee on Banking Supervision are analysing these issues, and in a few months we will begin publishing the results of these studies of the events in March.

So, having now advertised some of our work on crypto-assets and on the recent banking turmoil, I can now turn to the topic that I'd like to spend the rest of the time on: non-bank financial intermediation or NBFI, which is the fancy phrase for what we used to call shadow banking. In his letter to the G20 Finance Ministers and Central Bank Governors that was published about two weeks ago, FSB Chair Klaas Knot stated that the FSB's work on NBFI "remains as important as before." I think that statement could be surprising in some ways. Shortly after some banking turmoil might seem like the wrong time to emphasise non-bank financial intermediation. It's almost like a person saying in the middle of a heat wave that it's as important as ever to make sure your heater is working. Yet, that is precisely what the FSB membership has emphasised repeatedly in meetings since the banking turmoil just a few months ago. Let me try to explain that, and to do that, I'll start 15 years ago, when I was on the secondment at the US Treasury Department that I mentioned earlier and we were working on the global response to the financial crisis.

Why is the FSB looking at NBFI?

For those of you who are less familiar with us, the FSB was established almost 15 years ago in the wake of the 2008 global financial crisis. In the aftermath of the crisis, global leaders agreed on sweeping reforms to the financial regulatory and supervisory framework. The multi-pronged reform agenda was launched at the G20 Leaders' Summit in London in 2009, and part of that reform agenda included the creation of the Financial Stability Board to take action to mitigate risks to financial stability and to coordinate the efforts of the international standard setting bodies, when necessary, to make sure that we don't miss anything.

In one of its early press releases, the FSB highlighted the tasks it was working on, which included (and I'm paraphrasing):

- making banks safer
- ending “too big to fail”
- mitigating bank-like risks in NBFI, and
- ensuring continuous functioning of core financial markets.

So, as you can see, from the earliest days of the FSB, NBFI was a focus. In late 2019, then FSB Chair Randal K. Quarles set up a high-level group within the FSB to guide the FSB’s work on NBFI and to give that work greater urgency, because there was a sense that the banking sector was more resilient, but that changes to the financial system had made the non-bank sector even more important.

Subsequent events supported his foresight, as shocks that hit the system revealed the need to address vulnerabilities in NBFI. The market turmoil, following the onset of the COVID pandemic in March 2020, for example, highlighted vulnerabilities associated with liquidity, leverage, and interconnectedness. Authorities took a wide range of measures to restore market functioning and to support the supply of credit to the real economy, including central banks providing massive, extraordinary assistance.

Since then, we have seen other instances where opaque structures and exposures surprised investors and led to market stress, such as the disruptions to some commodity markets after Russia’s invasion of the Ukraine and the strains in the gilts market last autumn related to liability-driven investments by UK pension funds.

This brings me back to the events of earlier this year in the US and the Swiss banking systems. In March, Silicon Valley Bank (SVB) came under pressure, and there were several reasons for this including the effects of the rising interest rate environment, the concentrated exposure of the bank, and what appears to have been some bad risk management decisions. When SVB failed, markets started looking for other banks that had similar profiles, and some of those banks have now disappeared as well. Contagion spread market concerns from a single bank to other banks that ‘looked’ similar.

Now let me ask you, which of the factors that I mentioned that contributed to SVB’s decline was unique to banks. The rising interest rate environment? Nope. Banks and non-banks are dealing with the same rising rate environment. The concentrated exposure? Surely there are some non-banks that have large exposures to a single industry or to a small group of industries, including crypto or fintech firms. Bad risk management? We’ve seen in some of the events of recent years that bad risk management is not unique to banks. That’s why, when the events unfolded earlier this year, FSB members were emphatic that we had to keep our focus on NBFI. Global regulatory reforms had made the banking sector more resilient. A global systemically important bank – Credit Suisse – disappeared, and yet the banking system and the global financial system absorbed the shock without a crisis developing. Risks in the non-bank sector were going to be harder to spot, but we had to be more vigilant than ever.

So many of the vulnerabilities in the financial system are common to banks and non-banks. Perhaps a key difference between banks and some non-banks is that the non-banks are not supervised or regulated in the same way, and as a result it may be harder to identify non-banks in some industries that may have the same risk profile. Markets were able to quickly identify the most vulnerable banks because of the transparency required by their regulators and supervisors. Identifying non-banks that have the same profile may be more difficult. For example, we can gauge the interest rate risk that banks are holding with some accuracy – and that's in part why the markets were able to identify banks that were potentially vulnerable in the same way that SVB was. So, if markets are reasonably confident that banks are managing their interest rate risk right now, who is holding the interest rate risk? If it's not the banks, it must be somewhere in the non-bank sector.

Before I go on, I should note that I have tried to be careful with the words I've used. I haven't said that all non-banks are different from banks. I said some non-banks. This is because when you say non-banks or NBFI or even shadow banking you are lumping together a diverse group of institutions and activities including insurance companies, pension funds, money market funds, open and closed end funds, hedge funds, finance companies, broker dealers, and family offices. The term non-bank financial intermediation is a more accurate description of the important role this sector plays in financial markets than shadow banking, although the term shadow banking highlights the perceived lack of transparency in the sector. Now I think that "shadow banking" is less shadowy today than it was 15 years ago, but I still think it is more shadowy than the banking sector. Using a term such as NBFI to describe about half of the financial system's assets and making blanket statements about the sector is dangerous. I will try to be careful with my words so as not to indict half of the global financial system, when the issues I will raise are found in only some pockets of the category we label as NBFI.

The FSB and NBFI

Now that I've explained why the FSB chose to keep its focus on NBFI and acknowledged the difficulty of talking about half of the financial sector with one term, let me get more specific by talking about what the FSB's priorities in this area are.

Through our ongoing surveillance, the FSB has been highlighting vulnerabilities associated with liquidity mismatches and leverage in NBFI. Both vulnerabilities are sensitive to a tightening of financial conditions and a slowing of economic activity. (The banking sector is not unique in that sense.)

Turning first to liquidity, where our work is more advanced, the events I referred to earlier have repeatedly highlighted that the functioning and resilience of the NBFI ecosystem depends on the availability of liquidity and its effective intermediation under stressed market conditions. If liquidity imbalances become sufficiently large and pervasive, they may give rise to financial instability. These imbalances can be the result of the interaction of large and unexpected shifts in liquidity demand, insufficient supply of liquidity in stress, and various amplification mechanisms. The interactions can give rise to fire sales and the transmission of stress to other parts of the financial system and the economy.

One focus of FSB work in NBFI is, therefore, on what we call "key amplifiers" of liquidity stress, which are types of NBFI activities and entities that may contribute to the transmission and amplification of shocks due to their size, structural characteristics and behaviour in stress.

On the liquidity demand side, this includes activities that give rise to liquidity mismatches between daily or frequent redemption possibilities on the liability side and not enough liquid assets on the asset side. This is particularly prevalent in some types of non-bank entities, such as certain money market funds and open-ended funds. It also includes derivatives and securities activities that can give rise to unexpectedly large margin and collateral calls, currency mismatches associated with external funding, and the unwinding of levered positions that can exacerbate liquidity strains.

On the liquidity supply side, this includes factors that reduce the ability of bank and non-bank liquidity providers to absorb large spikes in liquidity demand, as well as other impediments stemming from the structure of core wholesale funding markets, which are characterised by limited standardisation, low levels of automated trading and turnover, and heavy reliance on dealer intermediation.

We have not been simply studying these vulnerabilities. We have come quite a ways in just a few years in making policy recommendations, and our members have been diligently implementing those recommendations. Our proposals to address systemic risk in NBFI largely involve repurposing existing micro-prudential and investor protection policy tools, rather than creating new ones. Our policy work has focused on a couple of areas.

First, reducing spikes in demand for liquidity. This includes policy actions on open-ended funds. On this, we have recently published – and are consulting on – revisions to the 2017 FSB Recommendations on Liquidity Mismatch in Open-Ended Funds, to enhance clarity and specificity and to make the Recommendations more effective from a financial stability perspective.[2] Our work also includes the policy proposals we issued in 2021 to address vulnerabilities in money market funds,[3] as well as work to enhance the liquidity preparedness of market participants for margin calls and to reduce the procyclicality of margining practices.

The second area of policy work focuses on enhancing the resilience of liquidity supply in stress. In April 2022, we published analysis of vulnerabilities stemming from the reliance of non-US firms, especially in emerging markets, on US dollar funding and identified potential ways that authorities in those markets could address them.[4] We also identified steps that individual authorities could take to increase the use of central clearing and of all-to-all trading platforms to enhance liquidity for bond and repo transactions. And, we are examining the structure and liquidity provision in core funding markets, including the role of different investors and factors that limit their resilience in stress.

Let me now turn to our work on leverage. The work on leverage is still in train and is less advanced than the work on liquidity mismatches. In September, we will deliver a report to the G20 that examines NBFI leverage trends in FSB member jurisdictions and associated financial stability risks, zooming-in on a couple of key entities such as hedge funds. This analytical work is a precursor to launching policy work in this area.

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2 See Financial Stability Board (2023), *Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – Revisions to the FSB's 2017 Policy Recommendations: Consultation report*, July.

3 See Financial Stability Board (2021), *Policy proposals to enhance money market fund resilience: Final report*, October.

4 See Financial Stability Board (2022), *US Dollar Funding and Emerging Market Economy Vulnerabilities*, April.

As recent market incidents have demonstrated, if not properly managed, the build-up of leverage creates a vulnerability that, when acted upon by a shock, can propagate strains through the financial system, amplify stress, and lead to systemic disruption. It does this through different channels, such as the unwinding of positions in response to margin calls or potentially the default of a counterparty that was too heavily levered. Disruptions can be further amplified by factors such as the amount and concentration of leverage, market participants' risk management practices (or lack thereof), and liquidity imbalances in leveraged non-bank investors and in the markets they operate in.

Leverage can be in the form of financial or synthetic leverage and can be either on- or off-balance sheet. Available data suggest that non-bank financial leverage in FSB member jurisdictions is significant and similar in scale to household debt, but that it's unevenly distributed within the sector. While insurance companies, pension funds and investment funds represent two-thirds of non-bank assets, more than 90% of on-balance sheet financial leverage is concentrated in other types of financial intermediaries, such as broker-dealers, hedge funds, finance companies, holding companies, and securitisation vehicles.

Amongst non-bank investors, hedge funds display high synthetic leverage in aggregate, obtained through securities financing transactions and derivative positions. Within the hedge fund sector, there is a group of funds, typically pursuing macro and relative-value strategies, with very high levels of synthetic leverage. In addition, large hedge funds usually spread their borrowing across several prime brokers, which helps diversify their funding sources but can also make leverage in the financial system harder to identify. Furthermore, a few prime brokers dominate the provision of lending to hedge funds, and this concentration could amplify shocks and propagate them through the financial system.

Leverage that is difficult to identify or measure by market participants or public authorities is referred to as 'hidden leverage'. In some cases, leverage is hidden because no data are available to assess its presence or its magnitude. In other cases, leverage can be hidden because available data are not sufficient or adequately used to assess vulnerabilities. The limited availability of data, problems in aggregating existing data, and difficulties in estimating meaningful measures of leverage may lead to an underestimation of overall leverage in NBFI and to the inability to identify large and concentrated positions. In addition to hampering vulnerabilities assessments, this impedes mitigating measures from being put in place by market participants and regulators.

The FSB will soon begin work to consider potential policy recommendations for mitigating the financial stability risks from NBFI leverage.

Conclusion

Let me now conclude. The current combination of high inflation, lower growth, and tighter global financial conditions may crystallise vulnerabilities in NBFI. The more limited policy space could make it more difficult for authorities to intervene should a shock materialise, and it underscores the need to remain vigilant and to take ex-ante policy measures to maintain the resilience of the financial system.

Enhancing resilience in NBFI will ensure a more stable provision of financing to the economy and reduce the need for extraordinary central bank interventions. The FSB will deliver a progress report to the G20 in September, which will include our main findings across the different areas I have outlined and policy proposals to address systemic risk in NBFI.

I chose to speak about NBFI because of its potential as a financial headwind. The vulnerabilities I've been discussing with liquidity mismatches and leverage are the sorts of things that can be a tail wind for a while, supporting economy activity, but can swiftly turn into headwinds when a trigger occurs: Leverage builds up during expansions, and this fuels economic growth. When a trigger happens, then market participants deleverage and you get a headwind. As we saw in some financial market events in recent years, things can change quickly. That is why we prepare now. That is the task that was assigned to the FSB almost fifteen years ago.