FedFin Client Report

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FSB Plans ASAP Action Not Just re NBFIs, But Also Bank Interconnections, Market Vulnerability

Client Report: **NBFI**

Executive Summary

As promised again just last week, the Financial Stability Board today released a "holistic" plan for dealing with NBFIs along with an ambitious agenda for global standards as soon as next year. FSB Chair Quarles' letter today reiterates as does the report that global banks largely proved resilient through the crisis even though market-making capacity was reduced, increasing NBFI risk. The FSB states that non-government MMFs, open-end funds, and leveraged hedge funds threatened the integrity of core markets in March and survived largely due only to central-bank support (which creates both risk to central banks and moral hazard). Urging structural change to NBFIs, the FSB concludes that another crash is likely in its absence unless central banks again step in. Although the NBFI plan does not stress the sovereign "doom loop" as a March risk factor, its detailed analysis determines this occurred; Mr. Quarles' letter includes sovereign-debt vulnerabilities among the issues again on the FSB's radar. The FSB's detailed analysis also discusses NBFIs such as insurers and pension funds, but does not single them out for the international work plan following which significant regulatory changes for NBFIs, especially non-governmental MMFs and leveraged hedge funds, may well ensue. However, the FSB is focused on interconnections between banks and NBFIs, looking at an array of issues such as the extent to which non-U.S. banks depend on dollar-denominated MMF funding and market interactions. Margining reform to ensure that dealers have sufficient variation-margin capacity is also on the to-do list.

Analysis

The lengthy FSB report includes an extensive analysis of events in March that precipitated market crises, as well as a description of how NBFIs changed as post-2008 bank regulation came into force. NBFI risks that were exacerbated by new interconnections with banks evident during the March crisis include:

- significant outflows from non-government MMFs;
- similar, if less intense, dynamics in some open-end funds;

- liquidity redistribution due to variation-margin calls for which dealers and end-users were ill-prepared;
- reduced primary-dealer willingness and capacity to intermediate in core funding markets, along with significant challenges for new-entry electronic dealers. Significant operational issues also challenged liquidity flows, while sharp funding-line drawdowns constrained banks even as banks depending on dollar-denominated MMF inflows faced significant challenges; and
- dislocations in government-bond markets due in part to leverage-amplified stress. Significant operational stress was also evident.

Based on these conclusions, the FSB also notes that dollar-funding market interconnectedness with FX and domestic-bond markets raises an array of structural questions; FSB plans an extensive mapping exercise to identify remedies. The FSB work plan otherwise includes:

- short-term evaluation through 2021 with an eye first to non-governmental MMFs, other types of open-end funds, margin-call readiness, core-market funding, and the structure of core funding markets;
- enhancing understanding of interconnectedness not only with regard to funding markets, but also between banks and NBFIs and those due to cross-border spillovers. The role of public policy will also be assessed to target moral hazard and resulting risk with work also examining the extent to which shocks in March were generated from within or outside the financial system. These projects advance as quickly as possible, with solutions advanced even as other research continues; and
- work to strengthen NBFIs without damaging their market function. No specifics are provided, but something is set to happen in 2022 according to the work plan.

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