PIIE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

THE FINANCIAL STABILITY BOARD'S ROLE IN GUARDING AGAINST RISING NONBANK RISKS

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To: The Chair of the Financial Stability Board
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Background: Banking having been at the center of the global financial crisis, it is not surprising that the most conspicuous impact of the Financial Stability Board's (FSB) work since then has been in relation to bank capital and bank resolution. But the FSB's charter does *not* limit it to—and does not even emphasize—the banking subsector of finance. The FSB must more energetically guard against nonbank risks that have grown over the past few years and look likely to dominate the next decade. It also needs to deepen its engagement with risks in and from emerging and developing economies, and work to raise its game in information technology–related supervisory dimensions such as big data and cyber risks.

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Because microprudential supervision has been designed mainly to protect the payments system and the deposit insurance system, prudential supervision regimes for nonbanks are far less intrusive and comprehensive than those for banks. But on the scale that they operate at present, the activities of large nonbank investment firms threaten financial and economic stability in ways other than imposition of losses on retail creditors.

The financial market panic in March 2020 revealed how much of the sources of financial system stability risk lies outside banking, with the scramble for cash resulting in dysfunction of what are normally thought of as the most liquid and resilient markets of all.

It is wholly unsatisfactory that a bunch of leveraged investment funds should have to be rescued in order to restore order to the most important safe asset market in the global financial system. Their threat to the global commons warrants commensurate regulation and supervision.

KEY PRIORITIES

PRIORITY 1: Rethink the approach to regulating nonbank financial firms

The FSB has not ignored nonbanks, but the experience of March 2020 should hammer home the increasing importance of nonbanks as amplifiers of systemic risk. Tighter regulation of banks, and the persistently low interest rate environment, have resulted in a migration of risk to nonbanks, many of them highly leveraged with venturesome business models that entail maturity mismatches.

The macroprudential regulatory safety net against systemic macroprudential risks needs to be widened and strengthened. The problem of where to set the boundary between what and who is regulated and who is not is a perennial one that has received some FSB attention but without triggering sufficient international regulatory initiatives.

Runs on near banks are not the only vulnerability that needs to be guarded against. Restrictions on leverage and maturity transformation are among the tools that might be needed, and on an international basis.[1] We are overdue a deep rethink that would result in a more specific and explicit common international framework for ensuring that macroprudential risks outside the banking area—and indeed beyond money market funds and insurance firms—are more effectively regulated and supervised.

PRIORITY 2: Fully engage China and other emerging-market and developing economies

Although it is already more than a decade since the G20[2] mandated the expansion of the membership of the FSB's precursor organization to include much wider representation beyond the traditional G10+,[3] the latter group of countries still tend to dominate the FSB's governance and agenda. At a time of shifting geopolitical power structures, maintaining the overall effectiveness of the FSB will require a new push for inclusiveness. It will be increasingly important to ensure full and active engagement of China and the other emerging-market and developing economies to ensure that its work fully reflects the growing importance of new financial centers from which future crises could emanate.

PRIORITY 3: Plug supervisory gaps in big data (and cyber-risk)

Supervisors need to better understand the ever-changing business models and playbooks of the major market participants in order to ensure that financial stability is not being placed at risk. Better stability-focused market intelligence is needed, both qualitative and quantitative.

This task will demand in particular more collection and assessment of fine-grained "big" data. Technical innovation in the collection and handling of big data is already widely recognized as essential to the future of financial supervision. The official sector is well behind the private sector in this regard, and comparatively little will be achieved if there is not a step change in the degree to which the relevant data can be collected and transmitted across jurisdictions.

An example here is the disappointing take-up of the initiative to assign legal entity identifiers (LEIs). (Strengthening systemic resilience to cyber-attacks is a somewhat related challenge.)

Progress will require careful analytical and legal work as well as practical international cooperation between supervisors at a much faster pace than has yet been achieved.

1 For example, one interesting recent proposal suggests loan-to-value ceilings for institutional real estate investment firms (Munoz, Manuel A. "Institutional real estate investors, leverage, and macroprudential regulation." *VoxEU*, November 14, 2020).

2 The members of the G20 are Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States.

3 The G10, established in 1962, is composed of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States, as well as Switzerland, which formally joined in 1983.

PRIORITY 4: Resolve the challenges of international digital currency

Intertwined with the question of improving regulatory access to and management of big data is the design of effective regulation of financial services provided by large technology/information (Big Tech) firms. The proposed Libra/Diem cryptocurrency and the importance of Big Tech firms in China and other emerging markets in providing payments and other financial services point to a potential concentration of market power (built on information as well as capital) in financial services worldwide in future years, presenting risks to the effectiveness as well as the stability of the system.

Partly in response, many central banks are now actively toying with the idea of creating some form of central bank digital currency (and the FSB has contributed to a wave of studies of the potential stability impact of such initiatives). However, the reluctance of central banks to go global with such initiatives indicates that the private sector will retain leadership in low-cost, efficient payments, including cross-border payments.[4]

The private and public initiatives in this area have the potential to destabilize national currencies, particularly in smaller economies. The FSB needs to get ahead of this risk.

TWO THINGS TO GUARD AGAINST

Watch out for side effects on inclusion and developing economies

While stability is its main focus, the FSB must not lose sight of the need to address the risk that measures adopted to promote stability could harm financial inclusion and economic development. It is not that regulations should be looser in low-income countries, but, if they are not to be counterproductive, their technical complexity must not exceed the local capacity to supervise and enforce. Voices from countries with less developed financial systems need to be better heard in standard setting.[5]

Resisting regulatory pushback on "too big to fail"

The failure to implement resolution systems designed to eliminate the problem of financial firms that are "too big to fail" (TBTF) points to a related problem. Admittedly, it does seem to be the case that large banking firms no longer command the same market advantage in funding costs that long reflected investor beliefs that they would be rescued by governments. But it is far from clear that failing large banks will indeed be resolved in a way that protects the public finances. Public authorities in Germany and Italy, for example, worked between 2016 and 2018 to avoid the application of the new European legislation on bank resolution, and public funds were provided to bail out creditors even of failed banks of only moderate size. These actions are not the only indications that the apparent political and technical consensus on the possibility and desirability of ending TBTF formed by 2013 likely requires defending.

4 Cf. Peter Bofinger and Thomas Haas. 2020. "CBDC: Can central banks succeed in the marketplace for digital monies?" *CEPR Discussion Paper* 15489.

5 Other examples would be the damaging effect on small countries' banking systems of inadequately nuanced anti–money laundering and combating the financing of terrorism (AML/CFT) safeguards.