LESSONS FROM COVID ON NON-BANK FINANCIAL INSTITUTION (NBFI) RISKS

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NBFI put to the test by March/April 2020 events: the issue of money market funds

Open ended funds were buffeted by the financial consequences of the Covid-19 pandemic, both on the asset side (drop in valuations, high volatility, derivatives positions undergoing significant margin calls...) and on the liability side (waves of redemptions). All of which constituted a live test of their ability to weather problems of valuation and of liquidity. Amid these trials and tribulations, money market funds (MMF) came under a specific pressure: they recorded the largest redemptions and in some cases subscriptions while short-end debt markets, in which they invest, were themselves severely unsettled.

Bank sponsors (Europe aside) and above all central banks intervened to steady the short-term debt sector, which, although no accident was recorded, stood out as a major source of risk to global financial stability. Indeed, MMF are one of the main investors in these instruments and thus participate directly in funding the real economy, absorbing a major part of short-term funding of financial, non-financial and public-sector institutions, whilst enabling corporate treasurers, institutional investors and investment funds to place their excess treasury or cash.

This episode was striking: the MMF sector was one of the epicentres of the 2008 financial crisis and, in order to reduce the risks to financial stability that are associated with their functioning, deep reforms were undertaken in all countries. Actually, the quality of assets held in their portfolio, notably their credit quality, did not raise any concerns in March or April.

The 2020 crisis was a liquidity crisis caused by exogenous factors and it leads us to raise the question of the need for further reform of this ecosystem and, ultimately, the legitimacy of bank disintermediation for funds that are meant to be highly liquid and risk free, that are considered as a substitute for cash and besides, fall within the scope of money supply in many countries when held by resident non-financial agents.

The framework within which money market funds operate must be reviewed and clarified.

Analysis of this episode however highlights the broad diversity of situations, notably when it comes to types of MMF. In the US, said Prime MMF invested in corporate paper recorded large redemptions while inflows into MMFs invested in public paper (Government & Treasury MMF) were nearly eight-fold higher. In Europe, USD & GBP-denominated low volatility MMF (LVNAV), registered in Ireland and Luxembourg and mainly held by non-Eurozone residents, underwent large outflows, in these same countries offset by inflows into USD-denominated constant price public debt MMF (CNAV). And EUR-denominated MMF valued at their market price (VNAV), the greater part of which are registered in France, underwent severe outflows which were more sustained than with other types of MMF overall while bank deposits of their historical holders tended to grow.

In fact, amid a particularly uncertain economic environment with the closure of certain market segments, MMF holders reacted according to a given fund's characteristics its asset profile and associated regulatory constraints. Somewhat unexpectedly some of these regulatory constraints could have spurred withdrawals and, in the case of EUR-denominated MMF, measures taken by the European Central Bank, targeting first the bond market, managed only belatedly to steady the situation.

This should lead, at least in Europe, to a review of the regulation and supervision of MMF and to find ways of enhancing the liquidity of the underlying money market, as well as to a clarification of the central bank's role with regard to these funds that are considered as monetary financial institutions.

At the same time, we must maintain the needs MMF fulfil: for an investor, holding a better yielding and safer liquid asset (more diversified than a straight bank deposit); for a financed entity, finding cheaper and more flexible funding via the short-term market as opposed to bank credit; for the bond market, smoothing its functioning by offering counterparties for long-end securities nearing to maturity.

Policy options currently considered are diverse and some of them very extreme; we should find the right balance in our regulatory stance in order to increase the robustness of MMFs without losing sight of their beneficial purpose.

FRANCESCO MAZZAFERRO

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Liquidity mismatches in the NBFI sector should be addressed

The spread of the pandemic and the lockdown measures imposed to contain Covid-19 triggered an adverse shock to the global economy and large falls in asset prices. Markets reacted by substantially repricing risk, as investors fled towards safe and highly liquid assets. Assets in the non-bank sectors fell by EUR 1.2 trillion (3.3%) in the first quarter of 2020, mainly due to large valuation losses resulting from asset price falls.

Outflows rose and contributed to the fall in assets under management across a wide range of fund types. Redemption flows appeared to largely reflect the increased risk associated with the underlying assets and/or the demand for cash to meet short-term liquidity needs. Liquidity mismatches in certain types of open-ended investment funds amplified market volatility in late February and early March.[1]

The sudden rise in volatility led to a large increase in variation margin calls, putting additional pressure on some investment funds' liquidity positions. Derivatives data reported under the European Market Infrastructure Regulation (EMIR) show that daily variation margin calls on euro area investment funds rose fivefold, from around EUR 2 billion in the first half of February to over EUR 10 billion in the second half of March.

For 27% of the funds for which EMIR data are available, daily variation margins exceeded their pre-pandemic cash buffers on at least one day during the period of market turmoil.[2]

A number of EU investment funds, particularly high-yield corporate bond funds and real estate funds, used liquidity management tools to help address outflows and valuation uncertainties. Some funds used quantity-based measures, such as suspensions of redemptions or redemption gates, while other funds used price-based tools, such as swing pricing or redemption fees, which impose the liquidity cost on the redeeming investors.

In response to these developments, the European Systemic Risk Board (ESRB) adopted a Recommendation to ESMA to coordinate a supervisory engagement with funds that have significant exposures to corporate debt and real estate assets.[3] In its response to the ESRB, ESMA noted that only a few funds have adjusted their liquidity set-up according to the pursued investment strategy and in light of liquidity strains they encountered.[4]

Liquidity management tools help address outflows and valuation uncertainties.

The vulnerabilities highlighted by the Covid-19 pandemic are not new and need to be addressed. In 2017, the ESRB issued a recommendation to ESMA and the European Commission on liquidity and leverage risks in investment funds.[5]

The most important messages were: (i) the development of a common set of liquidity management tools for investment funds across EU jurisdictions, (ii) further setting out the role of ESMA when authorities use their power to suspend redemptions, (iii) measures to limit the extent to which the use of liquidity transformation in open-ended alternative investment funds could contribute to systemic risks, and (iv) enhancements of data reporting requirements for all type of funds.

Another market that came under stress during March 2020 amid substantial outflows from money market funds (MMFs) is the short-term debt funding market. In case of market stress, MMFs may be reliant on banks, corporates or central banks to purchase their commercial paper back in order to raise cash and accommodate heightened redemption flows. This materialised during March 2020.

It is not the first time that MMFs contributed to the propagation and amplification of liquidity strains. In 2013, shortly after its creation, the ESRB had sent a recommendation to the European Commission on MMFs, requesting that Union legislation would require MMF to have a fluctuating net asset value and that stricter liquidity requirements be introduced. Despite the introduction of the Money Market Fund Regulation in 2017, which enhanced the regulatory regime for MMFs, vulnerabilities remain within MMFs and need to be addressed.

1. See EU Non-bank Financial Intermediation Risk Monitor 2020, ESRB, Oct 2020.
2. See Liquidity risks arising from margin calls, ESRB, Jun 2020.
3. See Recommendation of the ESRB on liquidity risks in investment funds (ESRB/2020/4).
4. See Report on the Recommendation of the ESRB on liquidity risk in investment funds, ESMA, Nov 2020.
5. See Recommendation of the ESRB on liquidity and leverage risks in investment funds (ESRB/2017/6).

NAUSICAA DELFAS

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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.

> **The financial system has proved to be a reliable and resilient source of funding [..] and we must ensure it remains able to be so in the future.**

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.

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Towards a more resilient NBFI sector

The resilience of European investment funds, including money market funds (MMFs), was tested by the large and widespread imbalances in the demand and supply of liquidity and the repricing of risk caused by the economic impact of the Covid-19 pandemic. Between 20 February and 20 March 2020, several funds investing in illiquid assets experienced severe outflows, sometimes in excess of liquidity buffers; cumulative redemptions from euro-area high-yield corporate bond funds reached 10 per cent of their assets under management (AUM). Outflows from MMFs in the central week of March reached 5 per cent of their AUM. Redemptions stabilised only after unprecedented central bank interventions that alleviated market stress.

Outflows from open-ended funds and MMFs were driven primarily by institutional investors. Insurance corporations and pension funds invest largely in MMFs primarily for liquidity management purposes. Distress in other parts of the non-bank financial intermediation (NBFI) sector spilled over to the investment funds' sector, amplifying liquidity strains. Recent research shows that institutional funds tend to act procyclically, by actively investing in higher yielding, longer-duration and lower-rated assets as spreads compress, ultimately affecting asset price volatility. In some cases, redemptions from institutional investors occurred due to the need to cover exceptionally high margin calls resulting from heightened market volatility.

In other cases, liquidity pressures on institutional investors were associated with a significant mismatch between assets and liabilities; this is the case, for instance, of some unit-linked policies, where insurance companies hold assets whose liquidity profile does not necessarily match with the daily redemptions frequency offered to policyholders.

An increased need for cash amplified both intermediaries' demand for highly liquid assets and the potential for forced asset sales by investment funds. Interconnections among non-bank financial intermediaries' balance sheets also contributed to propagating and amplifying the stress.

Non-bank financial institutions experienced broadly similar episodes of stress. In general, liquidity risks in the NBFI sector contributed to the international transmission of the financial shock induced by the pandemic. The "dash for cash" episode in March 2020, for instance, led to severe strains in the dollar funding market, thus affecting entities that borrow in US dollars worldwide.

The G20 Italian Presidency will lay out the stepping stones of a macroprudential approach to NBFI regulation.

The increasing role of the NBFI sector in financing the economy and the vulnerabilities seen last year renewed a policy debate on the adequacy of the regulatory and supervisory framework for these intermediaries. Given the global dimension of the issues, the multilateral setting provided by the Financial Stability Board (FSB) and the global Standard Setting Bodies is most suited to adopt a common approach aimed at increasing the effectiveness of the framework and preventing fragmentation.

Last December, Italy assumed the Presidency of the G20, with a commitment to the full implementation of the FSB workplan on NBFI. Building upon the FSB "holistic review", the work program includes a number of key deliverables to be submitted to the G20 later this year, including a report on policy options to enhance MMFs' resilience, as well as analytical work on vulnerabilities in open-ended funds that invest in illiquid assets and on potential procyclicality issues on margin calls.

The G20 Italian Presidency will lay out the stepping stones of a macroprudential approach to NBFI regulation, with the aim of contrasting the build-up of risk in periods of market exuberance and reducing the probability of central bank interventions.

GERRY CROSS

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Well calibrated policy responses required to mitigate potential vulnerabilities

At the onset of the Covid-19 shock, as financial markets turbulence, a 'flight to safety' and heightened demand for cash generally swept through a range of markets, investment funds experienced a sharp increase in redemptions and challenges in liquidity management. At an individual level, the vast majority of funds managed to meet investor redemption requests. However, this needs to be seen in the context of unprecedented central bank interventions that played a key role in restoring market functioning.

Of particular concern to regulatory authorities were sector-wide dynamics evident during the period of stress. The potential for collective behaviour of funds to add to market-wide pressures in periods of stress requires regulatory change.

As an integrated central bank, prudential, conduct and AML/CFT regulator, macroprudential and resolution authority, the Central Bank of Ireland approaches regulation of the funds sector in the light of our statutory mandates of safeguarding monetary and financial stability, securing the proper and effective regulation of financial service providers and markets, and ensuring that the best interests of investors are protected. Following the COVID shock, three areas require particular scrutiny in our view.

As the Covid crisis began to unfold, Money Market Funds (MMFs) saw a substantial increase in redemptions and a deterioration in the liquidity of their assets. Redemptions were concentrated in MMFs with investments in private sector debt and this led to liquidity management challenges for those MMFs. While all MMFs managed to meet redemption requests, had any been forced to suspend redemptions or fail to meet key expectations, liquidity stresses could have spilled over to other parts of the financial system.

The interconnectedness of MMFs with other parts of the financial system – including banks and other non-banks – means their resilience in periods of stress can be systemically important. Regulatory authorities are currently examining ways to strengthen MMF resilience in light of the lessons learned.

Effective liquidity management in open-ended investment funds, particularly those which invest in less liquid assets, is also an area of particular focus at present.

Funds dynamics contribute to market-wide pressures in times of stress and requires regulatory change.

Such funds, as evidenced during the Covid-19 shock, are particularly susceptible to the risk of large redemption requests during periods of market stress and may have to sell assets quickly in order to meet such redemption requests. The redemption patterns observed during March and April 2020 in such parts of the funds sector are consistent with the operation of first-mover advantage dynamics.

There is a need to develop additional measures to address this issue. This could include measures to ensure that the costs associated with such redemptions, including increased liquidity premia in times of stress, are fully borne by the redeeming investors.

Finally, there is a need to enhance the macro-prudential framework for investment funds. The lack of a complete and operational macro-prudential framework for funds in Europe and internationally remains a key gap which is correctly gaining more attention following the recent market events.

Market-based finance, and the funds sector in particular, provides a valuable alternative to bank financing, supporting economic activity. However, like all forms of financial intermediation, they may also contribute to the build-up of financial vulnerabilities. It is important following the lessons learned from Covid shock that well calibrated policy responses are introduced in order to mitigate such vulnerabilities.

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A lesson from Covid-19: liquidity risk management is central to open-ended funds

March 2020 saw market liquidity deteriorate significantly – as many companies, banks, and investors looked to cut their risk and raise cash – and an extreme stress test of the previous decade's reforms. While UCITS and AIF outflows rose sharply to relative levels last seen during the Great Financial Crisis, they remained manageable, and the overwhelming majority of funds met all redemptions.

Strong fund liquidity management was instrumental in achieving this, and managers deployed tools ranging from swing pricing to suspending redemptions to protect their investors. Their availability was thanks to efforts post-2008 by IOSCO, ESMA, regional and national regulators to raise the bar for liquidity risk management. By 2020 best practises had been incorporated into many fund rulebooks, building on existing EU rules – for example in the UCITS Directive – to manage liquidity risk.

Funds suspensions were rare in March 2020, and mainly a response to idiosyncratic price uncertainty in regional real estate and bond markets: Fitch estimate that 0.11% of global fund assets were subject to suspensions during the turbulence; ESMA estimate 0.8% of EU-domiciled corporate bond UCITS were. Use of swing pricing – a mechanism for allocating a variable premium or discount to transactions in or out of funds – was more prevalent, and meant redeeming investors paid the higher cost of accessing liquidity. And while the primary purpose of swing pricing is to protect fund investors, from a systemic perspective it incentivised shareholders to remain invested; or spread redemptions over time.

To fully realise these benefits going forwards, use of swing pricing or similar 'anti-dilution' measures must be comprehensive. ESMA data on last year's turbulence shows swing pricing was used by many but not all EU funds. We strongly support extending implementation of the full liquidity risk management toolkit in all EU member states. This should also be accompanied by efforts to encourage the practical adoption of the tools by all fund managers.

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An alternative suggestion – requiring funds to hold more 'High Quality Liquid Assets' – misunderstands fund liquidity. The notion that funds went into March 2020 with depleted 'liquidity buffers' incorrectly applies a bank regulation concept – HQLA – to asset management. Funds aim to meet redemptions while maintaining a risk-constant position over time, not by tapping cash buffers. In challenging market conditions, even high yield bonds could be sold to meet redemptions.

Asset liquidity, and fund liquidity in turn, vary with market conditions and position size. Assumptions around both are continuously and rigorously tested by fund managers as a matter of course and in line with regulation (indeed in March 2020 EU fund managers were mid-way through implementing ESMA's new liquidity stress test standards for UCITS and AIFs).

Macroprudential policy measures would be at best ineffective, and at worst pro-cyclical. Open-ended funds only hold a portion of assets: McKinsey data shows asset managers accounted for 27% of global financial assets by end-2019, of which funds are only a sub-section. Attempts to manage system-wide conditions via macroprudential controls on funds would therefore be ineffective, missing most assets.

And their effects may instead be counter-productive: some recommend mandatory cash or liquid asset buffers for funds, to be drawn down during stresses. Notwithstanding the performance drag, a buffer insufficient to meet redemptions will likely leave a portfolio more concentrated in risk assets to meet any subsequent outflows.

Achieving system-wide resilience should follow a three-pronged approach.

First: make individual products and activities as robust as possible, for example by giving all funds the full liquidity management toolkit.

Second: ensure banks can play their role as market intermediaries, setting prudential limits that strike a balance between safety and smooth market operations.

Third: evolve market structure to reflect bank balance sheet constraints: many fixed income markets would benefit from modernisation – with more use of central clearing and electronic all-to-all trading venues – while securing quality, comprehensive, real-time data for all asset classes through a European consolidated tape would improve transparency and liquidity.

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The Global Health Crisis – A real-life stress test of MMF reform

The market stresses experienced in March/April of 2020 were the result of an unprecedented Global Health Crisis the likes of which has not been seen since the Spanish flu over a hundred years earlier. It was not a financial crisis. The stresses experienced were the predictable and obvious result of chaotic and uncoordinated responses of governments around the world and their affirmative decisions to shut-down global economies.

The disruptions were not caused by structural vulnerabilities in money market funds (MMFs). Conditions in the real world affected the markets, not the other way around. And the market impacts were felt first in equities and commodities, later in bond markets, then in money markets and finally in MMFs.

The only appropriate comparison of the Health Crisis with the 2007/09 Financial Crisis is the perpetuation of a false narrative that MMFs caused or exacerbated each crisis. Accepting this false narrative blindly allows policy makers to ignore the more complicated issues that need to be addressed to ensure that financial markets operate in a crisis. In a crisis, the implementation of emergency liquidity assistance to financial institutions is a core responsibility of central banks. They are the lenders of last resort. They serve this role, not to preserve MMFs, but to preserve liquidity and stability across markets. Whether central banks serve in this capacity once in 12 years, twice in 12 years, or 3 times in 100 is of no consequence – it is the role they are intended to serve when markets are placed under extreme pressure.

The real problem to be addressed is not MMFs, but the systemic illiquidity and seizing up of markets that are essential to financial stability. Many regulators fail to distinguish between systemic liquidity events and systemic credit events. This distinction is essential for understanding today's reform debate.

Global regulators are currently focused on potential MMF reforms included in the President's Working Group (PWG) Report. Most of the policy measures discussed in this report have been previously considered and rejected because they would negatively impact the viability of MMFs to the detriment of investors, issuers and the capital markets generally.

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However, one of the proposals does address the key issue which impacted MMFs in the Health Crisis – and that is the decoupling of the weekly liquid asset requirement from a necessity to consider the imposition of a fee or gate. This bright line trigger was adopted by global regulators, despite industry warnings, and served as a catalyst for investor redemptions. It should be removed.

We do, however, believe that a MMF's board should be permitted to impose liquidity fees or redemption gates when doing so is in the best interest of the fund and its investors to prevent unfair dilution, without reference to any specific level of liquidity. Additionally, we believe requirements to maintain minimum levels of liquidity and knowledge of one's investor base should remain, as they are appropriate and necessary safeguards for investors. The benefits of such requirements were evident throughout the Health Crisis.

The experience of MMFs throughout the Health Crisis should be applauded, as despite frozen markets and delayed central bank action, all MMFs were able to fully meet investor redemption requests. The Health Crisis was a real-life stress test of the global MMF reforms adopted after the Financial Crisis and demonstrated that MMFs were not only resilient, but that are instrumental to investors and markets and should be protected – not eliminated.

MMFs have been one of the most successful market innovations over the past 50 years. They improve market efficiency and stimulate competition by providing lower cost borrowing for issuers and higher returns for shareholders.

Since 1985, MMFs alone have provided over Eur 500 billion more in incremental returns to investors than bank deposit accounts and over this whole period only two prime MMFs have "broken the buck" at no cost to taxpayers. Meanwhile thousands of banks have failed, costing depositors and taxpayers Eur billions.

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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 egment

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.

How can we further protect this growing segment of the market - 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.