Nonbank Financial Intermediaries: Vulnerabilities amid Tighter Financial Conditions

Nonbank financial intermediaries (NBFIs) play a key role in the global financial system, enhancing access to credit and supporting economic growth. While recent market stress has focused on vulnerable banks, NBFIs’ financial vulnerabilities might have increased in the past, amid low interest rates. Case studies presented in this chapter show that NBFI stress tends to emerge with elevated leverage, liquidity mismatches, and high levels of interconnectedness that often spill over to emerging markets. In the current environment of high inflation and tighter financial conditions, central banks can face complex and challenging trade-offs during market stress, between addressing financial stability risks and achieving price stability objectives. Policymakers need appropriate tools to tackle the financial stability consequences of NBFI stress. NBFI direct access to central bank liquidity could prove necessary in times of stress, but implementing appropriate guardrails is paramount.

As a first line of defense, robust surveillance, regulation, and supervision of NBFIs are vital. Priorities should be to close key data gaps, incentivize risk management by NBFIs, set appropriate regulation, and intensify supervision. With these elements in place, the need for action by central banks should be reduced, or at least limited to financial stability risks, thereby mitigating the risk of moral hazard.

Central bank intervention should aim to address liquidity and not solvency problems, and should avoid conflicting with the monetary policy stance, especially in a tightening cycle. Central bank liquidity support involves three broad types:

1. Discretionary marketwide operations should be temporary, targeted to those NBFI segments where further market dislocation and disintermediation could have adverse financial stability implications, and designed to restore market functioning while containing moral hazard. The timing of a marketwide operation is critical—a framework should be in place based on what can be referred to as “discretion under constraints.” Data-driven metrics trigger the potential intervention (the constraints), while policymakers ultimately retain the discretion as to whether to intervene.

2. Access to standing lending facilities could be granted to reduce spillovers to the financial system, although the bar for such access should be very high to avoid moral hazard. Access should not be granted without the appropriate regulatory and supervisory regimes for the different types of NBFIs (some of which may not qualify).

3. Central banks as a lender of last resort may need to step in if a systemic NBFI comes under stress. Lending to a systemic NBFI should be at the discretion of the central bank, at a penal rate, fully collateralized, and accompanied by more supervisory oversight. A clear timeline should be established for restoring the liquidity of the institution.

Clear communication is critical, so that central banks are not perceived as working at cross-purposes, such as purchasing assets to restore financial stability while continuing with quantitative tightening to
bring inflation back to target. Announcements of central bank liquidity support should clearly explain the financial stability objective and the parameters of the program.

**Coordination between the central bank and financial sector regulators is essential**, not only for the identification of risks but also for the management of crisis situations as well as for an assessment of supervisory and regulatory deficiencies.

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