

# FOREWORD

**T**he *Global Financial Stability Report (GFSR)* has repeatedly highlighted how the financial regulatory reforms implemented since the global financial crisis have helped support global financial stability. Strengthened supervision and regulation, better crisis management preparedness and resolution processes, enhanced data collection, and a macroprudential approach to financial sector oversight have raised the financial sector's resilience to the multitude of shocks experienced in recent years.

Good policymaking, however, is a forward-looking activity. This is especially relevant today, as the structure of the global financial system is undergoing substantial transformations, most notably with the growing participation of nonbanks in financial intermediation (NBFIs). While these changes have been in train for some time, the magnitudes are becoming ever larger, with several drivers: (i) constraints imposed by postcrisis regulations on banks' leverage have encouraged diversification and the transfer of risk to other financial intermediaries; (ii) pension funds, insurance companies, and sovereign wealth funds have grown from 50 percent of global GDP to close to 90 percent over the past two decades, with much of their assets deployed to nonbanks; and (iii) new digital technologies are revolutionizing how financial services are distributed, how credit is evaluated, and how trading and market making are conducted.

This evolving nature of the financial sector landscape has positive implications for financial markets and economies worldwide. Market-based finance and nonbank credit intermediation have generated alternative sources of financing for firms, better capital allocation, and greater market efficiency through capital markets activity, private equity and private credit, hedge funds, and high-frequency market making and trading. The growth of NBFIs can also strengthen prospects for financial stability. A broader set of financial intermediaries with different risk profiles, time horizons, and expertise avoids overreliance on banks, increases competition, provides diversification to borrowers and investors, and creates mechanisms for risk

transfer away from the banking system. These benefits, however, are unevenly distributed across countries at the moment, with many advanced, emerging market, and developing economies remaining bank-centric and standing to benefit from further development of NBFIs and market-based finance.

While these benefits are likely sizable, reaping them requires policy steps to contain risks to global financial stability. Past GFSRs, for instance, have discussed vulnerabilities arising from liquidity mismatches in open-ended mutual funds, highly leveraged trading strategies used by hedge funds, and opaque interconnectedness in the broad NBFIs sector. The GFSR has also shown that, as nonbank financial institutions become vital to intermediation in core financial markets—such as government and corporate bonds—the availability of market liquidity in times of stress has come into question. Recent episodes of stress have required central banks to intervene. International standard setters are making progress in enhancing NBFIs resilience. It is paramount that these international policy initiatives continue expeditiously and that national authorities implement them in a timely and consistent manner.

Enhancing the resilience of the financial sector is particularly relevant in the current context, where both economic and policy uncertainty are elevated against a backdrop of rising geopolitical risks. As shown in Chapter 2, economic uncertainty increases downside risks to future growth, asset prices, and bank lending. Additionally, uncertainty can trigger cross-border spillover effects through trade and financial linkages.

## Thinking Through the “Future of Finance”

With the financial sector continuing to transform, it is imperative that policymakers think through the “future of finance.” Technological innovation in financial activities can increase efficiency and competition, while increasingly disrupting financial services traditionally provided by banks. Novel lending modalities for private credit are likely to continue growing,

artificial intelligence may support further growth in NBFIs (see Chapter 3 of the *GFSR*), and digital banks are growing in systemic importance.

Policymakers must ensure that the balance between benefits and risks in this new state of financial intermediation remains appropriate. Traditionally, *prudential regulation* of nonbanks tends to be either absent or less strict because they do not take deposits from retail investors and largely do not have recourse to central bank backstops. However, with the growth in the relative size of NBFIs and its close linkage with the banking sector, more substantive externalities may be generated, potentially requiring novel policy approaches. The regulatory framework needs to be proportionate to the systemwide risks posed by different institutions and acknowledge that risk-taking is needed for financial intermediation, as someone—not only central banks—should be there to “catch the falling knife” during stress times. However, policy must weigh the costs and benefits of such risk-taking carefully, and with broad financial stability objectives in mind. The discussion of the August 2024 turmoil in this edition of the *GFSR* is a recent illustration of this challenge. When volatility spiked, many leveraged investors reached risk limits and received increased margin calls, which forced them to rapidly close their positions. Such practices helped protect individual institutions from a potential worsening of the turbulence but also caused nonlinear effects that likely exacerbated the sell-off. Therefore, regulation and supervision of NBFIs also need to consider broader financial stability objectives.

Making the most of the ongoing transformation and ensuring that the financial sector can sustainably fuel economic growth requires further progress on several fronts:

- **Expand data collection:** Regulators need to collect more comprehensive data on NBFIs that allows a better evaluation of the risks to global financial stability and a more complete map of the interlinks of the sector. Information on the use of leverage and asset holdings will allow the development of more effective policies to address systemic risks while avoiding stifling financial innovation.
- **Increase transparency:** Nonbanks tend to be relatively opaque and often do not provide enough information to investors and the public. The growing potential for spillovers from NBFIs to the broader financial system and the increasing participation of retail investors require more transparency. Conduct requirements, including public disclosure, are also important to support market discipline and price discovery.
- **Design appropriate liquidity facilities and backstops:** Liquidity stress in the NBFIs sector can spill over to the broader financial sector—as seen during stress episodes such as the March 2020 dash-for-cash—and eventually to the real economy. In such circumstances, central banks may face a trade-off between providing support to NBFIs—and therefore safeguarding financial stability in the short term—and introducing moral hazard whereby NBFIs can rely on central banks to resolve the fallout from excessive risk-taking. If market stress occurs during periods of high inflation and monetary policy tightening, another trade-off could also arise between the central bank mandates of financial and price stability. Consequently, it is necessary to develop mechanisms for central bank support that minimizes moral hazard and encourages nonbanks to internalize liquidity risks. Communication plans that avoid central banks being perceived as working at cross purposes, such as purchasing assets to restore financial stability while tightening monetary policy to fight inflation, are also critical.
- **Improve the financial “plumbing”:** A diverse financial system requires an underlying “plumbing” structure that allows for the smooth movement of money and assets. Maintaining trust in the system requires ensuring that financial transactions are safely completed even in times of stress. It is therefore key to ensure that payments and settlements systems work effectively and securely. In this regard, it is first order to continue working toward ensuring interoperability (for example, that different systems and platforms work together seamlessly, especially on a cross-border basis) and integrating new technologies including artificial intelligence to enhance efficiency and security.
- **Enhance the resilience of central counterparties:** The international regulatory reform agenda after the global financial crisis called for the use of central counterparties (CCPs) for clearing certain types of derivatives. The shift toward CCPs created a more robust and transparent financial system but also increased their systemic importance, making it paramount to enhance their resilience. This requires ensuring that CCPs have enough resources to cover

potential losses, business continuity plans are in place, and recovery and resolution plans clearly outline the measures a CCP will take to restore its stability or wind down its operations if it fails. Margining requirements also need to be reviewed aiming not only to protect the CCP but also to consider the impact that margin and collateral calls during times of stress might have in the broader system.

- **Undertake a systemic approach to enhancing resilience of NBFIs:** Vulnerabilities in the NBFIs sector can amplify shocks and have systemic implications. For instance, liquidity mismatches in bond funds may add selling pressure in times of stress; significant increases in margin calls in the derivatives market may create systemic liquidity stress during times of elevated market volatility; and the failure of highly leveraged nonbanks, such as in the case of Archegos, might generate substantial losses for banks. Despite the potential for significant negative externalities from NBFIs, the prudential framework for NBFIs in most countries is focused on specific institutions and sectors and does not include system-wide and cross-sectoral perspectives. The absence

of a macroprudential perspective for nonbanks means that, during good times, risks in the NBFIs sector can grow and create externalities throughout the financial system. It is necessary for the relevant authorities to coordinate more closely in order to ensure that sound governance structures, mechanisms, and processes to monitor NBFIs from a systemic perspective are in place. It is also necessary to sharpen existing tools and potentially develop new ones to address potential systemic risk.

This is a long and challenging list. In summary, the ask is to enhance the prudential framework to address systemic risks from a larger NBFIs sector while also considering that leverage facilitates financial intermediation and that interconnectedness means more efficient capital mobility and allocation, which is the core role of the financial sector. The IMF is ready to continue working with its member authorities, other international finance institutions, and global standard-setting bodies to achieve these goals.

Tobias Adrian  
*Financial Counsellor*