Authorities in the dark over key area of financial system, IMF report shows

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Since the eruption of the global financial crisis in 2008 and the ongoing financial storms, the latest in March when two US banks collapsed and the globally significant bank Credit Suisse had to be wound up in a forced takeover, two fundamental features of the global financial system have become ever more apparent.

First, that measures undertaken by central banks to stave off a crisis at one point by pouring money into the financial system only create the conditions for its eruption at another.

Second, that the authorities supposedly in charge of the system have no real idea of the workings of the financial monster they have created, much less any coherent plan for its regulation.

Anyone who may have had some doubts about the validity of these assertions need only consult the International Monetary Fund's *Global Financial Stability Report* issued this week at the IMF-World Bank spring meeting in Washington.

It now widely acknowledged that the central banks' program of quantitative easing, spearheaded by the US Fed after 2008 and then accelerated after the crisis of March 2020, created conditions where a series of financial institutions, including banks, would be vulnerable to the rapid rise in interest rates over the past year.

However, such was the faith of the Fed in the efficacy of its policies that, while it devised a series of stress tests to measure the strength of the banks, it failed to include their ability to cope with a sharp rise in interest rates.

This is only one expression of a far broader process, which emerges with particular clarity from a reading of Chapter 2 of the report dealing with the rise of nonbank financial institutions. These have come to play an ever more prominent and dangerous role in the operation of all financial markets.

The chapter begins as follows: "Nonbank and market-based finance has experienced spectacular growth since the global financial crisis. During this period, the share of global financial assets held by nonbank financial intermediaries (NBFIs) has grown from about 40 to nearly 50 percent of the total."

This rapid rise was in part due to regulations introduced after 2008 to try to control some of the more speculative activities of the banks which led to the 2008 financial crash. According to the report, while these regulations made the banking system "more resilient," they "effectively pushed activities to other parts of the financial system."

In other words, like water, which always manages to find gaps and weaknesses in a plumbing system, predatory finance capital found ways to continue the very same speculative activities that led to the crash.

The report notes that NBFIs have come to play a key role in core financial markets, such as government and corporate bonds, and are a crucial driver of capital flows to emerging markets and developing economies.

"At the same time, vulnerabilities related to financial leverage, liquidity and interconnectedness have built up in certain segments of the NBFI ecosystem. Particularly dangerous is the interaction of poor liquidity with financial leverage."

In other words, NBFIs have raised large amounts of money, much of it through debt, often short-term, which is invested in risky assets, which become impossible to unload (illiquid) during a period of financial turbulence, meaning there is difficulty in repaying investors and lenders when they seek to withdraw their money.

The most striking feature of the chapter is that financial authorities are totally in the dark about many areas of the system they are supposed to control. This is set out throughout the report. The instances of ignorance are too numerous to list in full, but some glaring examples provide a picture.

"Very low rates and asset price volatility since the global financial crisis have incentivized investors and institutions to use financial leverage (debt) to boost expected returns. However, vulnerabilities from leverage can sometimes be unknown to both authorities and market participants because they are difficult to measure or because the leverage is hidden."

The report notes that liquidity stress in the NBFI sector can spill over to the broader financial sectors as took place in the March 2020 "dash for cash" when the $22 trillion US Treasury market, the basis of the global financial system, froze at the start of the pandemic.

However, financial authorities have no real idea of the interconnectedness of NBFIs with the broader financial system. As the IMF report notes, while there is some data, "large gaps remain" with "roughly half of aggregate NBFI domestic funding sources unaccounted for."

It said regulatory data gaps for NBFIs are "significant" in inhibiting the ability of regulators to monitor systemic risks.

"Significant data gaps exist for monitoring the liquidity vulnerabilities of investment, money market, and hedge funds."

Data gaps are a "key hindrance" for leverage analysis of investments funds, and leverage disclosures for investment funds that are not hedge funds "are often not detailed enough to allow for assessments of the extent of leverage that is visible to regulators."

Data gaps loom even larger for unregulated or even unregistered types of NBFIs, such as family offices like Archegos Capital, the demise of which in 2021 played a role in the eventual demise of Credit Suisse. And the list goes on.

At the press conference on the report, Tobias Adrian, the director of the IMF's Monetary and Market Capital Markets Department, sought to brush away concerns about the stability of the financial system.

Asked whether central banks could raise interest rates in their so-called fight against inflation while maintaining financial stability, he acknowledged that the March crisis had revealed "vulnerabilities" and there were "other vulnerabilities out there."

There were vulnerabilities but there were also policy tools and they had "deployed in a very effective manner." The so-called policy tools consisted of nothing more than the deployment of billions of dollars to bailout uninsured depositors holding more than $250,000, at the failed SVB and Signature Bank, some of them with tens of millions of dollars in their accounts, as the Fed provided additional liquidity to the banking system.

Adrian sought to present these actions as a smooth operation, proceeding as if according to a plan. In fact, as various accounts have made clear, it was nothing of the sort and involved a series of crisis meetings, including Treasury Secretary Janet Yellen, Fed chair Jerome Powell and the head of the Federal Deposit Insurance Corporation, Martin Gruenberg, among others.

He continued to promote the claim that SVB was an "outlier" with no lasting significance for the banking system. He did not explain, nor did any of the assembled journalists ask him, if that were the case, why authorities had to invoke the threat of a "systemic crisis" in order to organise the rescue operation.

Adrian's responses recalled that of European Commission president Jean Claude Juncker who said during the euro crisis in 2011 that "when things get serious, you have to know how to lie."