How Risk-Free Is the Global Financial System?

By Mohamed A. El-Erian

Too early to tell.

In recent weeks, policymakers on both sides of the Atlantic have affirmed that the financial system is sound and stable. The U.S. Federal Reserve announced in June that all U.S. banks passed its latest annual stress test. And Fed Chair Janet Yellen has now suggested that we might not experience another financial crisis "in our lifetimes."

At the same time, the Financial Stability Board—which monitors regulatory practices around the world to ensure that they meet globally agreed standards—has declared, in a letter to G-20 leaders, that "toxic forms of shadow banking" are being eliminated.

In short, ongoing measures to buttress the global financial system have undoubtedly paid off, especially when it comes to strengthening capital cushions and cleaning up balance sheets in important parts of the banking system. The latest assurances from policymakers are comforting to those of us who worry that not enough has been done to reduce systemic financial risk and to ensure that banks serve the real economy, rather than threaten its wellbeing.

Yet it is too soon to give the financial system as a whole a clean bill of health. Efforts to shore up the banking sector in some parts of

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Europe are still lagging far behind. And, more important, financial risks have continued to migrate to non-bank activities.

After irresponsible risk-taking almost tipped the global economy into a multi-year depression in 2007–2008, regulators and central banks in advanced economies launched a major effort to strengthen their financial systems. To that end, they focused initially on banks, which have since bolstered their risk-absorbing capital cushions, cleansed murky balance sheets, increased liquidity, enhanced transparency, narrowed the scope of high-risk activities, and partly realigned internal incentives to discourage reckless behavior. Moreover, the process for resolving failing and failed banks has been improved.

It is too early to declare victory.

In addition to strengthening the banking sector, policymakers have also made progress toward standardizing derivative markets and making them more robust and transparent, which also reduces the risk of future taxpayer bailouts for irresponsible institutions. Moreover, the system for payment and settlement has been made safer, thereby lowering the threat of a "sudden stop" in economic activity, like the one that occurred in the fourth quarter of 2008.

It has been encouraging to watch national authorities coordinate their efforts under the auspices of the FSB. Better coordination has reduced the risk of regulatory arbitrage, and addressed the threat that banks will be, as former Bank of England Governor Mervyn King memorably put it, "international in life but national in death."

Another systemic financial crisis likely won't originate in the banking system.

The United States and the United Kingdom took the lead on reform, and Europe has been catching up. Assuming that it does, as policymakers there intend, Yellen's assurance of a "much stronger" banking system in the United States will apply to all of the other systemically important banking jurisdictions in the developed world, too. And the FSB's confident assertion that "reforms have addressed the fault lines that caused the global financial crisis" will receive more support.

Still, it is too early to declare victory. Although the FSB describes the financial system as "safer, simpler, and fairer," it also acknowledges "nascent risks that, if left unchecked, could undermine the G-20's objective for strong, sustainable, and balanced growth."

As an observer and participant in global capital markets, three of these risks stand out to me.

First, as more carefully regulated banks have ceased certain activities, voluntarily or otherwise, they have been replaced by non-banks that are not subject to the same supervisory and regulatory standards.

Second, certain segments of the non-bank system are now in the grips of a "liquidity delusion," in which some products risk over-promising the liquidity they can provide for clients transacting in some areas—such as high-yield and emerging-market corporate bonds—that are particularly vulnerable to market volatility. And at the same time, exchange-traded funds have proliferated, while financial intermediaries have shrunk relative to bigger and more complex end users.

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Third, the financial system has yet to feel the full impact of technological disruptions fueled by advances in big data, artificial intelligence, and mobility, which already are in the process of upending a growing number of other established sectors. And the financial-technology (fintech) activities that have expanded are inadequately regulated, and have yet to be tested by a full market cycle.

To be sure, another systemic financial crisis that threatens growth and economic prosperity worldwide likely won't originate in the banking system. But it would be premature to assert that we have put all the risks confronting the financial system behind us.

Because risks have morphed—and migrated out of the banking system—regulators and supervisors will have to step up their efforts and widen their focus to see beyond the banks. After all, as Greg Ip of the *Wall Street Journal* pointed out in 2015, "Squeezing risk out of the economy can be like pressing on a water bed: the risk often re-emerges elsewhere. So it goes with efforts to make the financial system safer since the financial crisis." ◆