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On flood management and financial stability

It is a pleasure to be back at the Eurofi Financial Forum. This time in beautiful Budapest, near that stunning Parliament Building.

I find cities that are built on riverbanks especially appealing. There is something about water that is soothing and energizing at the same time. But there is also something about it that keeps you on your toes. Something dangerous.

Those of you who live here, in Budapest, will surely remember the high tides of the Danube last winter. Eventually the river breached its banks, right here around the corner, and flooded the otherwise bustling streets. Luckily, without too much damage.

In the Netherlands, we know the dangers of rising water levels all too well. One disaster in particular has become a core part of our collective memory.

During the night and early morning of February 1st 1953, the combination of high spring tide and a severe windstorm led to 'a storm tide'. This storm tide eventually breached the Dutch dikes and flooded the land beyond. Almost 2.000 people died and another 72.000 became displaced and homeless. And the damage to houses, streets and fields was unimaginable.

After this disaster, known as the North Sea Flood, it didn't take the Dutch Government long to take action. Within a year, work began on an elaborate flood defense system of dikes, dams and coastal storm surge barriers: the Delta Works. And the Delta Works have defended the Netherlands from such a catastrophe happening again ever since.

Remarkably, the reason the Dutch government could take action so quickly, was because concerns already existed about the resilience of the Dutch dikes before that disastrous early morning in 1953. Indeed, the plans for the Delta Works were already on the table. But due to a lack of funding and other priorities, they were not yet implemented when that deadly combination of water and wind hit the coast.

Now, I wouldn't be telling you this story if I didn't see a parallel with our fields of expertise – and the dikes and defenses we try to build to safeguard these fields from flooding.

Going back to 2008, I think it is fair to say that very few saw the Global Financial Crisis (GFC) coming. The devastation of the Great Depression had faded from people's memories, as well as the kind of deregulated finance that had caused it. Instead, markets were widely believed, once again, to be able to regulate themselves.

This time, even though the international regulatory community was caught off guard when the GFC struck, they were determined to ensure this would not happen again.

And so, the global financial system underwent a much-needed reform. You could say the international regulatory community effectively constructed its own version of the Delta Works for the worldwide banking system.

Beyond banking, however, the story is somewhat different.

Even though banks were at the epicenter of the GFC, non-bank financial intermediation (NBFI) played an important role in that very crisis. And, already a decade before, in 1998, the failure of the 'Long-Term Capital Management' hedge fund had alerted us to the systemic risks that non-bank financial institutions could pose.

Reforms, however, have been modest. The complete Delta Works for NBFI is still being designed. And that design is not yet implemented.

This is worrying, especially since NBFI – the investment fund sector in particular – has continued to generate systemic risk in recent years.

For instance:

- In March 2020, we witnessed the market turmoil and 'dash for cash'.
- In 2021, the collapse of the hedge fund Archegos followed.
- And in 2022, we saw the strains in commodity markets, and the UK gilts crisis.

These events were threatening enough to market functioning and financial stability that central banks and public authorities were forced to come up with immediate and extraordinary policy responses.

We now know very well that the NBFI sector faces structural vulnerabilities, including structural liquidity mismatch in open-ended funds, leverage that can create financial stability risks, and inadequate margin preparedness. And, the NBFI sector is highly interconnected with the rest of the financial system.

As we have seen, these vulnerabilities can, in the event of an external shock, amplify market stress and propagate through the broader financial system. This happens mainly via a sudden or large rise in demand for liquidity, typically brought about by rapid selling of assets to meet redemptions, the need to deleverage, or to meet margin calls.

When similar financial entities – particularly investment funds – with similar investment strategies, sell similar assets, with a similar timing, asset prices may fall and a vicious downward spiral of further falling prices and forced selling may ensue. Subsequently, stress may spill over to other parts of the financial system, either directly to counterparties, for example when leverage is involved, or indirectly through mark-to-market losses on common asset exposures.

Of course, market-based finance will not necessarily result in threats to financial stability. On the contrary – especially in Europe – the real economy, the financial sector, and investors could benefit from more diverse funding channels and investment opportunities. As such, I wholeheartedly support the EU's Capital Markets Union policy agenda.

However, if we want to harness the benefits of market-based finance, we also need to put in place appropriate safeguards to protect financial stability. In this regard, I consider the recent stress episodes in NBFI to be clear signs of rising water and swelling winds – signs that underscore the urgency for constructing a Delta Works equivalent for the NBFI sector, and to do so before an even bigger storm hits.

To this end, global standard setting bodies (SSBs) and national authorities are doing a great deal of analytical and policy-oriented work. Let me briefly mention a few initiatives.

- After the events of March 2020, the FSB published several policy proposals to enhance money market fund resilience.
- In 2023, working closely with IOSCO, the FSB revised its policy recommendations on addressing vulnerabilities stemming from structural liquidity mismatch in open-ended funds, while IOSCO issued new guidance on anti-dilution liquidity management tools.
- Earlier, the BCBS-CPMI-IOSCO reviewed margining practices in centrally and non-centrally cleared markets. In a follow-up to this review, later this year the FSB will publish its final recommendations to enhance the liquidity preparedness of market participants for margin and collateral calls.
- Currently, the FSB is working on policies to address NBFI leverage-related financial stability risks.
- In connection with this, the Basel Committee on Banking Supervision (BCBS) has recently consulted on guidelines for counterparty credit risk management, also in relation to non-bank entities.

The main concern of SSBs is systemic risk in NBFI. To this end, their policy proposals aim to reduce liquidity demand spikes, or at least mitigate the impact on financial stability. Otherwise, they aim to improve the resilience of liquidity supply in stressed market conditions. Additionally, the SSBs encourage authorities and market participants to increase their risk monitoring frameworks and use this information in their resilience planning.

Drawing up these policy recommendations, however, is not enough to stem systemic risk in NBFI. In the end, the success or failure of these policies depends on their swift and proper implementation by member jurisdictions.

The NBFI sector is global in nature. As such, implementation needs to happen at the same time and with a sufficient degree of consistency across all major jurisdictions – to avoid cross-border fragmentation and regulatory arbitrage.

Safeguarding financial stability also relies on effective cross-border cooperation and adequate data sharing arrangements. All jurisdictions need to strengthen their part of the common dike against rising water. A breach in one part of the dike may have consequences well beyond a single jurisdiction.

We did this for the banking sector after a severe crisis. I am convinced the regulatory community will manage to do this for the NBFI sector too – but this time before a new major crisis hits.

The European Union is an important player in this regard. We are in a unique position to lead-by-example when it comes to the implementation of globally agreed standards.

I believe that the recent review of the European regulatory framework for investment funds will bring about important changes, once it is transposed into national law – changes that will include, for example, additional requirements for liquidity management tools to address liquidity mismatch in open-ended funds.

But more work remains to be done. As such, the ongoing Consultation on the Macroprudential Framework for NBFI by the European Commission provides a great opportunity to set out a clear path for the future.

Let me briefly address five areas where progress could and should be made, and where I believe the incoming European Commission will have its NBFI work cut out for it.

First, regarding liquidity mismatch in open-ended funds: to fully comply with the 2023 revised FSB recommendations and the accompanying IOSCO guidance, more actions are needed beyond the recent amendments to the main European investment fund regulations. For instance, the incoming Commission should consider regulatory guidance and, possibly, further legislative amendments to encourage consistent use of anti-dilution liquidity management tools under both normal and stressed conditions. And efforts must be made to implement the FSB's recommendation to classify funds by their liquidity profile, and adapt redemption terms and conditions to the liquidity of the fund's asset portfolios.

Second, the new European Commission should take action to implement the FSB's 2021 policy proposals for money market funds. While the previous Commission recently decided not to review the MMFR anymore, other jurisdictions have either raised the liquidity requirement for MMFs, like the US, or proposed to do so, like the UK. The 2024 FSB's thematic peer review on money market fund reforms highlighted that there is significant variation between jurisdictions on minimum liquidity requirements. Europe should follow suit to close this regulatory gap and improve the resilience of EU MMFs.

Third, the FSB is preparing policy recommendations on enhancing margin preparedness of market participants for margin and collateral calls. Once finalised, the European Commission should work on the implementation of these recommendations. Doing so will also help reduce liquidity pressures for money market funds.

Fourth, to address leverage-related risks, the European Commission should aim to implement the FSB's minimum haircut framework for securities financing transactions. Additionally, the Commission should consider further reforms based on ongoing work by the FSB on NBFI leverage.

And last but not least, as FSB Secretary General John Schindler mentioned in his contribution here at Eurofi yesterday, having high-quality data is of crucial importance. It is therefore necessary to keep a close eye on any initiatives to solve data-related challenges. And European authorities should take a supportive role on the global stage to make progress, especially in sharing data.

Let me wrap up.

In Amsterdam, I live in a neighborhood close to the river Amstel. In an area that lies five meters below sea level. But I don't have a fear of floods. Because I know that measures have been taken to safeguard the city and the people living in it.

Unfortunately, I don't feel the same level of reassurance yet when I speak about NBFI. For that to happen, we need much more implementation of global standards. Much more cross-border cooperation. Much more consistency across jurisdictions.

And so, I urge everyone involved to implement the 'Delta Works for the NBFI sector' – just like we did for the banking sector after the Global Financial Crisis. But this time, let's not wait for the water to rise and the winds to swell. This time, let's get ahead of it.

Thank you.