Financial stability in Europe

Introduction

The Chair explained that the discussion would focus on the main risks posed by radical uncertainty and non-bank financial intermediation (NBFI). The radical uncertainty in European public life, influenced by an interplay of both internal and external factors, makes it very difficult to price certain risks, such as global terrorism or a global pandemic. Nevertheless, the EU financial system has been generally stable. After a long period of very low interest rates, there has been a sharp tightening of financial conditions in different segments of the market. Although there is always a need to work on the "unknown unknowns", regulators and supervisors should feel confident: they have been able to cope with all the challenges so far.

1. The regulatory response to radical uncertainty

1.1 The fiscal situation around the world is worrying

An official explained that the debt-to-GDP ratio has risen significantly around the world and in some EU countries, but there are few plans for fiscal consolidation. Demographic trends, increased defence spending and the fight against climate change are placing increasing demands on governments. These developments are worrying because high levels of public debt can affect financial markets. As debt increases, interest rates become more sensitive to policy rates as risk premia rise, which could test the financial intermediation capacity of markets. Financial markets could also become more volatile. Government bonds are used as benchmarks for pricing other assets and as collateral. Any sharp movement in government bonds spreads very quickly, generating further volatility and exacerbating existing vulnerabilities. This was evident in the sovereign bank doom loops in the euro area debt crisis (2020-2012) and the US gilt stress in September 2022. So far, markets have been complacent, benign or sanguine about these fiscal developments, but markets do not usually behave in a linear fashion. As Rudi Dornbusch said, crises take a long time to materialise and then they materialise very quickly.

1.2 Addressing geopolitical and political uncertainty

1.2.1 Geopolitical and political uncertainties can affect the private sector in many different ways

A regulator emphasised that geopolitical and political uncertainties can destabilise financial markets and act as a catalyst for existing vulnerabilities. In the aftermath of the 2022 Russian invasion of Ukraine, the volatility in the nickel market was exacerbated by large positions which were spread across several clearing members, meaning that counterparties were unable to see the full size of the concentration. Pre existing vulnerabilities were exacerbated by the dash for cash, the collapse of Archegos, the nickel crisis and the liability driven investing (LDI) crisis.

1.2.2 The resilience of the banking sector

A Central Bank official agreed that Europe is going through a decade of uncertainty. In any period of uncertainty there is always a search for stability. The banking system is stable and part of the credit for that should go to the supervisors. Capital and liquidity levels in the banking sector are good. The level of non-performing loans (NPLs) is historically low. Before Covid and the war in Ukraine, it was unthinkable that NPLs would be between 2% and 3%. Banks need to have enough capital to pay dividends, meet their regulatory requirements and lend. Capital should not be a bottleneck to improving the economy through lending. In the longer term, any new initiatives should take into account the need for the banking sector to remain sound in times of uncertainty.

1.2.3 Stress testing can help supervisors and firms understand the complexity of geopolitical risk

A Central Bank official stressed that the regulation and management of geopolitical risk is highly complex. Many regulators have sought to improve the way regulated entities incorporate geopolitical risk into their models. In one of its Financial Stability Reviews, the European Central Bank (ECB) stated that banks should take a "proactive approach" to managing geopolitical risks, using a range of risk management and diversification techniques. It is not easy to create a good toolkit for this type of risk, as it manifests itself in many different ways. Given the high level of uncertainty, stress testing can be very useful. When a crisis or period of turbulence looms on the horizon, automated stress testing models can enable market participants and supervisors to understand and anticipate the potential impact. The Central Bank of Hungary is automating its stress testing model to speed up its understanding of the impact of crises; it is important for banks and other financial institutions to do the same.

1.2.4 High quality securities should be eligible as collateral to cover variation margin calls by central counterparties (CCPs)

An industry representative agreed that geopolitical shocks can have a significant impact on markets, particularly derivatives markets. During some of the shocks of the last decade, there was a so-called "dash for cash". One aspect of this dash for cash could be mitigated by adjusting the regulatory approach to variation margin requirements in centrally cleared markets. In centrally cleared derivatives markets, many CCPs only accept cash to meet variation margin calls. This creates a pro-cyclical situation as market participants seek cash to meet variation margin calls,

which by definition spike during a crisis. Allowing high quality securities, such as government bonds, to cover variation margin calls would reduce the procyclicality of the market in times of crisis.

1.3 Preparing for anything

1.3.1 Operational risk management is a key priority

An industry speaker explained that responding to the risk of cyber-attacks and disinformation campaigns is a question of operational resilience. Indeed, it is important to be prepared for anything. This risk cannot be mitigated by additional capital requirements. Banks and other financial institutions can deal with traditional risks, but these new risks cannot be modelled and can bring banks to a standstill. They can only be addressed by good risk management. The challenge for Europe is to simplify and coordinate its regulatory framework rather than introduce additional capital requirements. Passing on the cost of capital to customers hampers growth, and the lack of uniformity in global requirements creates an uneven playing field. The Chairman noted that it is not clear whether cyber risk could ever be fully insurable, as the full extent of potential operational disruption from cyber risk is notoriously difficult to quantify. If it is not insurable, cyber risk will change significantly.

One industry speaker emphasised that the core of the issue is risk management. It is about supervision rather than regulation, and it is microprudential rather than macroprudential. The ECB has done well to push for strong risk management frameworks, but it is also important to consider the resilience of the business model. There can be unanticipated changes in customer behaviour, as seen in the Silicon Valley Bank (SVB) crisis and the role of social media in that crisis.

1.3.2 The behaviour of asset managers in the face of risk and uncertainty

An industry representative explained that asset managers have to comply with fiduciary duties and regulatory obligations to monitor their investments, ensure the diversity of their portfolios and manage risks. Risk management is critical for any regulated asset management firm. This has been reinforced by the recent review of the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings for Collective Investment in Transfer able Securities Directive (UCITS). The two cornerstones of asset management are portfolio diversification and risk management.

1.3.3 Diligence, planning and optionality in facing the 'unknown unknowns'

One industry representative noted that dealing with uncertainty is a matter of basic risk management. It is about due diligence, planning and optionality. The large global investors try to factor in geopolitical risk and sectoral change. The hardest part is dealing with the unknown unknowns that cause financial crises. Financial institutions need to make robust assessments of these hard-to-measure risks in terms of due diligence, scenario planning, global conflicts and crises. Global investors need to mitigate their own risk and identify those markets and institutions with unmitigated risk. Financial markets and the global regulatory environment are more interconnected than ever, but the volatile political environment in many jurisdictions is a recipe for uncertainty.

1.3.4 Transparency increases the resilience in the economy

One industry representative stressed the need for identifying what additional transparency is actually needed in financial markets. The work of the stability supervisors has been commendable in developing a common language for analysing systemic risk. However, there is still no universal definition of basic things like leverage, which would help to structurally mitigate risk. One of the key principles of risk management is that having more of one type of risk limits the ability to manage that risk. In the US, the diversity between private markets, public markets and banks provides diversification if one type of business model has a problem. In this respect, private markets play a very important role.

2. NBFI: strengths, systemic risks and regulatory challenges

The NBFI sector has grown significantly since the Global Financial Crisis (GFC). It currently accounts for around 55% of total financial assets, up from 45% immediately after the GFC. The importance of NBFIs in the financial system is increasing. In the euro area, NBFI assets have more than doubled since the GFC and NBFI institutions are estimated to provide 20% of all debt funding provided by all financial institutions (banks and NBFIs). The growth of the sector has brought many benefits, but also new risks. While the sector is heterogeneous and comprises a wide range of different types of entities, it is useful to classify vulnerabilities according to key categories such as liquidity and maturity mismatch, leverage and interconnectedness. In particular, the interconnectedness of the NBFI sector – although facilitates risk sharing in the financial system – is a key risk transmission channel. Despite considerable progress in recent years, much more needs to be done to implement an appropriate policy response.

2.1 The role of NBFI institutions and potential vulnerabilities in the sector

2.1.1 The growing importance of NBFI

A Central Bank official stressed that the high level of attention to NBFIs is required because NBFI entities now play an important role in financial intermediation. Broadly, financial intermediation has three characteristics: liquidity intermediation, risk transfer and the provision of payment instruments. Necessarily, financial intermediation involves a liquidity gap, a maturity gap and interconnectedness between transactions. Historically, these functions have been performed by banks. Thanks to innovation on various fronts, NBFI institutions now play an important role in the global market.

2.1.2 The level of systemic vulnerability is contingent on market conditions

A central bank official noted that the market conditions, i.e. the level or direction of interest rates, market volatility, and the creditworthiness of firms, could amplify the systemic impact of NBFI. In August 2024, the market experienced significant volatility due to the large unwinding of yen carry trade positions and positions related to equity derivatives by hedge funds. The market recovered quickly, partly because long-term investors such as pension funds and asset managers bought these shares at a lower price.

2.1.3 The NBFI sector is not monolithic

A central bank official emphasised that the NBFI sector is extremely heterogeneous. The risk profile of their business models varies across the segment and between individual firms. The sector includes insurers, pension companies, asset management companies, money market funds (MMFs), hedge funds, special purpose vehicles (SPVs), private equity funds or even family businesses. This heterogeneity is important when assessing the vulnerability of NBFIs. To fill this data gap and identify hidden leverage, supervisors and regulators need to have a strong dialogue with each segment of NBFIs.

One supervisor commented that securities regulators need to be involved in any discussion of the financial stability risks posed by NBFIs. As John Schindler explained in an earlier speech at the conference, the NBFI sector is not a cohesive or monolithic group of entities. When discussing the implications for financial stability, three main issues are usually considered: the size of the sector, the risk of liquidity mismatches, and the use of leverage. In order to understand whether there is a build-up of risk in the sector, it is important to ensure that methods are in place to detect concentration and interconnectedness.

2.2 Balancing the strengths of NBFI entities and the risks posed by their activities

An industry representative stressed the importance of diversification of funding. In the EU, 67% of non-government debt is held within the banking system, compared to 41% in the US. In the insurance industry, the figure is 13% in the US against 6% in the EU. This effectively doubles the amount of real economy credit provision in the US insurance industry. As everyone knows, banks borrow short and lend long. Insurance companies can borrow long and lend long. With long dated and forecasted liabilities, they are ideally suited to hold long dated assets that finance the needs of the real economy. Insurance companies provide senior financing to the US economy in a way that de-risks the system given stable liabilities. This type of financing also facilitates capital formation. If life insurers do not fund this part of the investment grade market, the equity market will have to be funded at a much higher cost as an alternative to the banking system. Finally, it is important to recognise that public markets are no longer able to provide the returns that insurance companies and other institutional investors require. Public markets are struggling in a number of ways. There is much greater concentration and fewer issuers. The real economy needs to be financed in a safe and stable way, mainly by private actors.

An industry speaker explained that some NBFI players are disintermediating the lending activities of banks. This poses a risk to financial stability as these entities are highly leveraged and concentrated and much less diversified than large banks. Banks provide liquidity facilities to these players, but they do not take equity type risks. This suggests that there should be some regulation of NBFI entities and a greater degree of transparency in the sector.

A central bank official stressed that the global economy is at a turning point in terms of inflation, monetary policy and geopolitical risks. If this leads to higher market volatility, it will structurally change the landscape. In Japan, the transition from a deflationary to a moderately inflationary economy will allow Japanese companies to reposition their business portfolios. Private equity and credit funds and asset management companies could play an important role in supporting this transformation, especially in channelling savings into investment. NBFIs will further activate financial intermediation by complementing banks' capital constraints. As half of the 2,000 trillion yen of Japanese households' financial assets are in the form of bank deposits, there may be room for NBFI institutions to offer new products and services. While there are financial stability concerns regarding non-banks, there are also opportunities for these firms to create real value.

2.3 Interconnectedness as a key vulnerability

A regulator observed that the non bank sector is an important source of liquidity and can absorb risk as well as amplify it. The evolution of NBFI is positive for the global financial system because it provides alternative sources of financing, promotes diversification and avoids overreliance on the banking system. However, it can also be a transmission mechanism for risk. Given the level of concentration risk, this interconnectedness will likely be a feature of the system for some time.

2.3.1 The NBFI sector is tightly connected to the banking sector

An industry speaker noted that the NBFI sector is closely linked to banks via the MMF market. Many MMFs are invested in sovereign wealth funds. EU MMFs hold both EU and non EU government debt and are used as short term funding vehicles for banks. Banks also provide credit lines to NBFI institutions. The average private equity or debt fund will have a large bank credit line. Therefore, if there is a deterioration in credit quality or a shock to the private markets, the bank will also be affected and could face significant liquidity needs through these credit lines. In Europe, banks often own investment funds directly. If a bank-related fund gets into trouble, the bank may feel obliged to provide support beyond its contractual obligations.

Data on banks' exposures to NBFI institutions are scarce. At a minimum, better data are needed to assess these linkages and vulnerabilities. NBFIs are

increasingly acting as counterparties to banks in cross-border activities. Banks' cross-border assets and liabilities to NBFIs have grown substantially in recent years, and this may also be an amplification channel. These examples only scratch the surface. More generally, it should be recognised that banks and NBFIs are no longer separate sectors. The current perception is that banking exposures are passed on to the NBFI sector, but the situation is much more complex. Exposures flow back to the banking sector in a variety of ways. In the case of insurance, exposures can be arranged across institutions and borders. Supervision, monitoring and regulation need to take a holistic approach, looking at the financial system as a whole and recognising that it is constantly adapting to new regulations.

2.3.2 The risk of interconnectedness underlines the need for international cooperation.

One supervisor stressed the importance of coordinated international work. The FSB is currently working on the visibility of non-bank leverage risks and possible mechanisms to address them. This could involve private or public disclosure, but the risks should be foreseeable before they materialise in practice.

An industry speaker noted that the insurance sector manages USD 35 trillion of assets worldwide. During the period of low interest rates, insurers started to invest more in riskier and less liquid private markets and alternative asset markets. Private equity firms have played an important role in this development, as many of them have acquired, taken stakes in or provided services to insurers. He noted that the complex web of interconnections between insurers and the rest of the financial system makes it difficult to predict the dynamics of a common shock to the insurance industry. This shows why international cooperation is crucial. The financial market is global, and it is impossible to look at financial conditions or activities on a jurisdiction-by-jurisdiction basis. A central bank official agreed that policy coordination among relevant stakeholders is key to realising the opportunities presented by the NBFI sector.

2.4 Regulatory challenges

2.4.1 NBFI data is key for enhanced risk monitoring

A central bank official stated that the fear of cross-contamination indicates the need to collect data on NBFI institutions. In Hungary, non-banks need a licence to lend. It would be useful to bring all types of supervised entities under one integrated authority. In case of a crisis in any part of the market, it would be clear whether this activity was financed by a bank. If the same authority collects all the relevant data, there will be less cross-contamination. To this end, cross-border cooperation between supervisors should be strengthened. Cross-border data sharing will benefit the supervision of firms in all Member States.

2.4.2 Monitoring counterparty risk in NBFI players and banks

An industry representative mentioned that banks currently have to comply with counterparty risk rules, in particular due diligence, to ensure that their counterparties (including non-regulated NBFIs) do not contaminate their banking counterparties, as was the case in the Archegos crisis. Banking supervision should also be strengthened to ensure that banks carry out adequate due diligence on their counterparties, in particular non-regulated NBFIs. Proposing new guidelines for counterparty risk management may be reasonable (as currently proposed by the BCBS), but effective supervision of the existing counterparty risk assessment (including due diligence) banking rules is also crucial.

2.4.3 Extending the scope of regulation to non-regulated players and enhancing market surveillance

An industry representative commented that there are both regulated and non-regulated entities in the NBFI space. As such, being a regulated entity, such as a regulated Asset Management Company, means it is directly known by regulators, which is not the case for non-regulated NBFIs. It should be a priority for legislators to extend the scope of regulation to the currently non-regulated players, such as family offices. Regulation facilitates direct knowledge and information by regulators regarding those entities. This is the surest way to anticipate and reduce systemic risk. In addition, the tools currently used by securities regulators to conduct their market surveillance legal mission should also be systematically enhanced, perhaps using AI, to improve the screening and detection of systemic actors, including non-regulated NBFIs.