FINANCIAL STABILITY RISKS IN EUROPE

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Staying ahead of the curve: financial policies in Europe

Europe's banks look solid: their aggregate Tier 1 capital ratio exceeds 16 percent, the liquidity regime is robust, and stress tests show resilience even in severe scenarios. Yet, just recently we saw how a failure of a US regional bank, Silicon Valley Bank (SVB), triggered a series of events that threatened Europe's financial stability. How could this happen?

The answer to this question is financial contagion. One channel of contagion is through counterparty exposures. These were minor for Europe in the SVB episode. Another potentially more capricious channel of contagion is market sentiment. In this context, even a small shock can become a "wake-up call", inducing market participants to reassess risks of seemingly unrelated financial institutions or markets.

Such contagion through market sentiment "gets in all the cracks". Markets seek out pockets of vulnerability and respond forcefully. This, arguably, befell Credit Suisse, a G-SIB. The bank had its challenges but was well-capitalized and highly-liquid and in the middle of a complex restructuring. Markets gave Credit Suisse some leeway, until the SVB's failure pushed them to reassess. Clients started to rapidly withdraw funding from Credit Suisse, and counterparty exposures to the bank became risky.

Decisive action quieted down markets. The Swiss authorities stepped in to stop adverse market dynamics, providing public support for an acquisition of Credit Suisse by UBS. Furthermore, all major central banks articulated their commitment to support financial stability without compromising on price stability. In particular, several central banks, including the ECB, announced their willingness to provide liquidity if needed, while continuing to use their main monetary policy tool—short-term policy rates—to control inflation.

But further jitters cannot be ruled out. For this reason, policymakers need to reassure markets that the financial system is resilient. Several measures can help achieve that:

- Supervisors can reduce uncertainty in markets by enhancing the transparency of banks' unrealized losses on hold-to-maturity security exposures. They should also continuously assess banks' liquidity, routinely perform interest-rate risk stress tests, and verify the stability of bank funding structures.
- As the financial cycle turns, banks need be prepared to deal with higher credit risk. Commercial and residential real estate prices may correct in several countries in response to higher interest rates, and corporate insolvencies and non-performing loans (NPLs) will likely rise as economic growth slows. To aid banks in this effort, supervisors should enhance the surveillance of emerging risks and policymakers around Europe should further expand the macroprudential toolkit.
- Policymakers must insist on a faithful implementation of Basel III standards. The IMF, alongside several EU regulators, expressed concerns regarding deviations from the agreed Basel III norms which came to light of recent EU legislative discussions. Indeed, the SVB failure speaks to the dangers of a selective implementation of bank regulation. Deviations from Basel III would make Europe's banks less safe.
- Recent events call for faster progress with completing the Banking Union. We anticipate that the ongoing EU review of the crisis management framework would expand the options for least-cost resolution of banks, covering also the less-significant institutions. The conclusion of the European Stability Mechanism (ESM) treaty ratification process would operationalize a financial backstop to the Single Resolution Fund. An agreement on the European deposit insurance (EDIS) would add credibility to any bank resolution arrangement.
- Capital Markets Union (CMU) initiatives are similarly consequential. The Commission's recent CMU legislative package for the first time includes steps toward harmonizing insolvency processes across member states. Stronger insolvency frameworks would expand firms' access to credit, help banks resolve NPLs, promote entrepreneurship, deepen European debt markets, and foster the green transition and economic convergence in the euro area.

The financial system has withstood the pandemic and the war in Ukraine thanks to forward-looking work by policymakers and regulators. Still, recent events made it clear that the process of building a more resilient financial system is far from over.

This contribution has been co-written by Alfred Kammer, Luis Brandao Marques and Lev Ratnovski, IMF.

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Financial stability does not equal zero risk

The global economy has suffered substantial shocks in recent years. The COVID-19 pandemic saw large swathes of economies shut down for months, while Russia's invasion of Ukraine led to energy price spikes, disruption to the supply of certain commodities, and intensified near-shoring of businesses' supply chains. One industry that fared better than most was the financial sector - but recent events are putting it to the test.

The financial sector's previously strong showing reflects substantial support provided by central banks and fiscal authorities during COVID. The Federal Reserve took decisive action in April 2020; government support with furlough schemes and other measures also limited the deterioration of banks' asset quality. The industry maneuvered through recent turmoil better than in 2007/8, but we must be alert to significant risks and shocks it still faces. Financial stability can never be about removing risk altogether; the essence of market economies is risk taking, which sometimes ends in failure. It is important to distinguish between pockets of risks within specific parts of the financial sector – and risks that threaten the stability of the financial system in its entirety. Crypto is a prime example, where recent disruptions in crypto markets and the collapse of FTX did not morphed into threats for the normal functioning of banks and other financial market participants.

Looking at European banks' earnings for 2022, it would be difficult to discern this was a year when war broke out on the continent. Great strides have been made since the Financial Crisis. Banks around the world typically have more capital and better liquidity than in 2006, and regulatory authorities remain alert. European banking systems saw significant shocks, and some are still working through the legacy of bad debts: ratios for non-performing loans in Greece and Italy are still above average but have fallen substantially since 2016. As ever, the risk landscape is constantly changing. Recent developments in the banking sector globally, show that even banks with good capital ratios can suffer a dramatic loss of confidence when fragile sentiment is combined with doubts over strategy and governance. The consequences of the acquisition of Credit Suisse by UBS, supported by significant government liquidity lines, still need to be played out.

As central banks continue with monetary tightening, the cost of capital is rising and leveraged borrowers and positions will come under more pressure. There is a danger of sudden withdrawals from open-ended funds, possibly triggered by investors becoming more risk-averse following adverse developments elsewhere in the financial system. Such contagion can be hard to stop unless funds have liquidity management tools (LMTs); open-ended funds are particularly exposed.

Sudden withdrawals can lead to forced sales of assets and destabilize markets. This happened during the UK's gilt crisis last autumn, following the Government's mini-budget. In principle, the gradual move towards higher yields are positive for the solvency of pension funds; but funding needed for margin calls relating to derivative positions forced the sale of assets – including gilts – that risked destabilizing the wider financial system.

Similarly, margin calls were at the heart of governments' need to support energy suppliers in summer 2022. Again, the underlying positions of the financial trades were healthy; but the cash needed to support massive margin calls as prices shot up were beyond what firms could afford. It is difficult to discern where the next financial crisis will come from. Market participants and policymakers need to be alert and nimble, like central banks and fiscal authorities in previous crises. But it goes beyond banking. There is need for greater transparency in asset management in particular; we need a clearer sense of where leveraged positions are to assess potential risks and spillovers to the broader financial system. Indeed, revisions to the European Alternative Investment Fund Managers Directive, currently being considered by the EU legislators, include possible rules on LMTs and disclosures.

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In bond markets, Moody's sees the next 12 months as challenging, but ultimately not presenting a systemic risk to the financial system. We forecast the global speculative grade default rate will increase from 2.8% to 4.7% over the period, well below the peaks seen in past credit downturns. Even in those instances, the bond market was often a symptom of wider systemic issues, rather than the trigger.

While financial stability does not mean all risk is eliminated, we all must remain vigilant on identifying new risks that could arise.

PETRA HIELKEMA

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Key lessons learnt from recent crises for long term investors

Over the last years the economy, the financial sector and insurance and pension industries have faced several unforeseen exogenous economic shocks such as the pandemic, supply chain disruptions, war in Europe and the energy crisis. Although European insurers and pension funds have successfully navigated the challenges, it is important to distil the key lessons to further improve the sectors' resilience.

At the outbreak of Covid-19, the main concern for the insurance sector was short-term financial market volatility, which has been well absorbed thanks to comfortable capital buffers. While the whole non-life sector with health, business continuity and worker compensation business lines came under scrutiny, it was the high uncertainty surrounding trade credit insurance claims and the risk of insurance coverage withdrawals that prompted a focused government intervention. The broader fiscal response also supported the economy and helped mitigate many potential negative effects.

Russia's invasion of Ukraine ended decades of geopolitical and security assumptions in Europe. While insurers' direct exposures were limited, the subsequent inflationary shock continues to pose serious challenges. For non-life insurers, the unexpected increase in the cost of claims has a negative effect on profitability with limited room for price adjustment due to competition while rising interest rates reduce the value of fixed income investments. Life insurers, which pay guaranteed returns in nominal terms, are less affected by inflation. Nevertheless, lapses may occur as investors seek higher returns elsewhere. Also, potential mid-term implications to the profitability and solvency amid reduction in underwriting and future profits might materialise. Here, supervisors and insurers must closely monitor developments together with potential mid-term implications on profitability and solvency and be ready to take appropriate measures to manage the risks.

Turmoil in the UK gilt market highlighted that if market movements are intense and fast enough, liquidity can be a risk for long-term liability driven investors like pension funds and insurers, where investments are concentrated in shallower markets. The ESRB highlighted liquidity risks in its September 2022 warning on vulnerabilities in the EU's financial system, suggesting that liquidity may be a wider concern. Although such a scenario cannot be ruled out entirely in the EU, the bloc seems less vulnerable to such risks as markets are deeper and derivative-using long-term investors tend to be well diversified in their holdings of fixed income investments so better positioned to cope with potential margin calls.

In March, several regional banks in the United States faced massive withdrawals of deposits, which ultimately led to the collapse of two of them. While triggered by bank-runs, one of the underlying causes relates to the sharp increase of interest rates in 2022 whose impact was not reflected into bank balance sheets due to the enforced book-value based regulatory regime. In the current situation, the risk of contagion through softer channels, such as reputation and fear, seems very high with the less robust banks being the first potentially facing severe consequences. European insurers have significant interlinkages with banks, particularly through investments in bonds. As a result, market corrections would lead to mark-to-market losses for insurers depending on individual exposures. That said, Europe's banking and insurance sectors seem well-capitalized to face current headwinds.

Insurers and pension funds have successfully navigated recent stress events but still headwind ahead.

From the crises shown above, a few valuable lessons can be learnt. First, as shown by the gilt crisis, long-term investors can both be subject to and generate liquidity shocks. Second, due to lack of substitutability, insurance activity can be potentially systemic, as demonstrated by the public interventions on trade credit insurance during the pandemic. Third, inflation is currently a material risk for insurers and assumptions used in the modelling are highly relevant to determine the value of Technical Provisions and capital levels. Fourth, when interest rates rise too quickly this can pose risks. It remains to be seen whether and to what extent the combination of inflation, which reduces consumer purchasing power, and higher interest rates will increase lapses on life policies in search for higher yields, putting insurers' solvency and profitability under pressure.

Bottom line: a robust supervisory framework based on a mark-to-market full balance sheet approach covering the whole risk profile of an industry is not a guarantee against crises, but it is key to containing the impact of adverse economic and market developments.

FRANK VANG-JENSEN
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European Banking needs a level playing field

The events in the financial sector that unfolded during March 2023 made many ask the question whether we are facing another financial crises comparable to the one that took place in 2007-09. First we saw the failure of Silicon Valley Bank in the US and then just a week later the rescue of Credit Suisse in Switzerland. Both of these situations escalated very quickly, almost out of the blue. By the time this article is published and read there may be additional developments that will have caused further turmoil. However, I feel that there are already important lessons that should be discussed.

In this article I will discuss two perspectives. The first relates to my confidence in the strength of the European banking industry as a whole, much of which is the result of strong prudential supervision and robust rules on capital, liquidity and risk management. The second relates to my concern about the lack of coordination in European macro-prudential measures and related buffers, and as a result, the clear absence of a level playing field and thereby a distortion of competitive factors between banks.

The troubles in the US were enabled by disparity of regulatory treatment. The medium sized banks were not subject to the same safeguards on liquidity as the major US banks following Basel standards. The Credit Suisse rescue shook markets, amongst other reasons, because the Swiss authorities did not follow the European standard approach to the treatment of investors. Our financial system is safe when it is subject to strong, stable and consistent regulation, applied in the same way to all. In contrast, banks that enjoy looser standards can attract business from those that follow stricter rules – and this will in turn create significant vulnerabilities in the financial system.

We have clear and harmonised EU rules and, within the banking union, SSM supervision as far as micro-prudential requirements are concerned, and we have a unified approach to recovery and resolution. All of these provide protection in the EU against similar events that we have seen in US and Switzerland.

However, even with the confidence I have on EU level regulation and supervision, I am deeply concerned about the absence of coordination within EU in relation to macro-prudential requirements, which still remain largely subject to national decision making. Macro-prudential buffers are inconsistently applied in the EU, and there appears to be no consideration of the total capital requirements faced by individual banks. The consequence is that banks can have vastly different capital requirements depending entirely on where they are located. It is the case that even banks that have similar relative size compared to their country of domicile face very different capital requirements What this means is that banks can have capital requirements that do not correlate with their risk profile. Such a deviation is not properly understood by investors. The turmoil of March showed that investor and depositor confidence in banks is paramount. Investor confidence in Credit Suisse was lost, its share price fell, depositors became concerned and withdrew their money. When confidence in banks is lost, no amount of capital will make up for it. At the same time, most of the banking sector is doing quite well, with low loan losses and improved profitability. This is very true for the lower risk Nordic banks that operate in resilient economies with strong social security systems.

Nordic authorities have been frontrunners in applying the macro-prudential tools to a greater extent than in other EU countries. This can be illustrated best with our situation at Nordea – we are subject to the high SSM micro-prudential standards and high Nordic macro-prudential buffers. This combination has driven our overall capital requirements higher than other major European banks. At worst, we see that macro-prudential instruments have been used as substitute for micro-prudential supervision. In addition, due to lack of consideration of their full impact, it is clear that certain requirements overlap and deviate from the ones faced by banks elsewhere with a similar low risk profile.

It is very difficult for investors to understand differences in capital requirements that do not correspond to the bank's risks. In this way, non-harmonised requirements can act against their intended purpose, and will harm banks' ability to compete on a level playing field and attract capital. Our unlevel playing field in capital requirements also interferes with the effective allocation of capital across banks and may inhibit cross-border mergers. As the EU Commission has acknowledged, we need to take action in Europe to harmonise the use of various macro-prudential instruments, covering all counter-cyclical and systemic risk capital buffer requirements. We also need to vest with the home supervisor the task of controlling the overall level of capital required from a single bank in order to manage the interplay and aggregate impact of the full set of different requirements. Recent events have clearly highlighted the need for consistency and level playing field. The common EU regulatory requirements and the accompanying supervisory and resolution regimes in the SSM should be trusted to do the job of delivering a strong financial system without significant country-specific deviations that remain unexplainable.

There is a temptation for regulators and supervisors to see capital as a solution to all problems. Capital did not help the US banks or Credit Suisse facing liquidity outflows. At the same time the economic outlook in Europe is unusual. After the fast recovery from the pandemic, the very long period of expansive monetary policy and then record-high inflation, the Russian assault on Ukraine and tighter financial conditions have all contributed to a challenging macro environment with increased uncertainty and lower consumer confidence. The regulatory response should not be to build capital buffers on buffers, but rather ensure that the rules we have are truly common and well-enforced. This is what is required to maintain the confidence in the safety of banks that can also support healthy growth in the economy. Capital and other prudential requirements need to be predictable and understandable across the board.