Implications of inflation, indebtedness and de-globalisation for finance

Introduction

The Chair noted four broad questions about this vast topic: dealing with the recent banking sector developments, the macro financial implications of high debt rates, the opportunities and challenges facing the financial sector in the current environment, and the relevance of economic security/strategic autonomy in the new geopolitical context.

Lessons can be drawn from the collapse of US regional banks and the takeover of Credit Suisse by UBS for the regulation and supervision of the EU and global banking systems.

1. Lessons drawn from the collapse of regional banks and the takeover of Credit Suisse by UBS

1.1 The US banking turmoil reveals a triple failure of management, regulation and supervision

An official stated there is a paradox because bankers one year ago were happy to see interest rates increase, but now there is the risk of rate increase.

The US regional bank crisis shows a triple failure. It is a failure of management not to deal with interest rate risk, duration and diversification, which were forgotten by the management of Silicon Valley Bank (SVB). It is a failure of regulation, as it was the 16th US bank not covered by Basel III since the Crapo regulation. It was a failure of supervision because many people knew what was happening but there was no remediation action by the supervisor.

An IFI representative argued that what happened in the US revealed primarily an issue of supervision. Following the tightening of the financial regulations after the Global Financial Crisis, focus needs to turn to implementation, and the quality and scope of the supervision. Lessons will have to be learnt by regulators on new developments in the market, such as increased fluidity of deposits, and the role of social media in this acceleration.

An industry representative stated that the first issue was on both sides of banks' balance sheets. For many years there were no interest rates as they were very low or event negative during the past decade and suddenly, they appeared with a vengeance. Many institutions were not prepared or forgot how to handle interest rate risks. On the supervisory side, not enough attention was put on how some institutions were handling interest rate risk.

1.2 European banks have weathered the recent banking turmoil in the US and Switzerland

1.2.1 A widespread banking crisis did not happen

An industry representative observed that a few lessons can be drawn from what is going wrong with the US banks. These are banks in crisis, but this is not a widespread banking crisis. There were three things affecting these banks. First, there were weaknesses in their business models. Second, there was weakness from a liquidity perspective. Lastly was the treatment of the interest rate risks affecting their bond portfolios.

An industry representative stated that the European system was very resilient. The response from the authorities and the political circle was effective. The old world and Europe have been hit in the last few years by incredible shocks. The response has been appropriate, both at the macro level and the market level.

1.2.2 The EU banking industry is resilient so far

An IFI representative added that the same contagion effects as 2008 are not seen looking at emerging markets in Eastern Europe and the European neighbourhood. There has been a great deal of work done since 2008 to strengthen the financial system and the banking system, including the Vienna Initiative.

1.2.3 Contrary to the US, all EU banks are subject to the Basel requirements

An official stated that the situation in Europe is very different. Unlike the US, all banks are under Basel III in Europe. There is high level of capital, a high level of liquidity, which is sometimes criticised, but there is also centralised supervision with the Single Supervisory Mechanism (SSM). There are old patterns like bank runs and new patterns like digitalisation, the use of social media and the velocity of the bank run. It is not time now to change the regulation. Basel III and the framework need to be implemented. There is a consensus text of the Council now in Parliament. Europe needs to be ready for 2025.

Secondly, there is a need to implement what has been decided. The Single Resolution Fund (SRF) should not be increased at this juncture. But the ESM backstop o this SRF should be implemented. The certification of the European Stability Mechanism (ESM) has been missed.

Finally, the question is whether the resolution of SVB should be copied. It was peculiar to see that the US administration decided to guarantee all the deposits. Cases have been seen where deposits were not guaranteed and were built in, in the US, Denmark and other jurisdictions. If the route is followed to guarantee all the deposits, there could be many good things, but there might not be an economic rationale. Moral hazards could be created for big corporates, so that they will deposit and not care about the situation of the banks they deposit into.

An industry representative noted that there are interesting statistics regarding the metrics that EU banks publish versus underreporting in the US market. For example, SVB did not have to report their Net Stable Funding Ratios (NSFRs). The US regional banks are significantly weaker on Liquidity Coverage Ratio (LCR) and other metrics reported than EU banks.

1.2.4 The EU responded quickly and appropriately to the fall of Credit Suisse

An industry representative advised that when risks present themselves it is important for authorities to come out with clear and rapid communication to calm markets. That happened in Europe in the wake of the additional tier 1 bond (AT1) issues in the Swiss market. It was important to re-establish the hierarchy of claims in the EU. Market risk remediated after that as a result.

1.3 The crisis should lead to reflections on the consequences of the speed of deposit flight in age of social media

1.3.1 Regulatory and supervisory tools need to adjust to social medial and digital banking

An IFI representative stated that the risk of black swans cannot be excluded in the current context. It is necessary to remain vigilant, taking into account the new phenomena of social media and the speed to withdraw deposits, which adds to the risks of sudden stops, compared to the GFC. Work is needed to adjust the regulatory tools to react better to this new reality.

An industry representative mentioned that the role of social media can be very devastating. In the middle of a panic, it can be a dangerous accelerator. Policies and companies have to be aware of this and prepare for how to respond. Things are not only going to change during a panic. Mobility of deposits is going to increase substantially because the technology is there, the financial literacy of the new generation will change, and the nature of deposits in a certain institution are more commercial than retail and will generate a need for banks and the banking institutions to look at deposits in a different way. This has implications on the business models and profitability of banks, and the way in which supervisors will look at the business model from the risk point of view.

1.3.2 Diversification of banks' funding sources is of the essence

An industry representative highlighted that one of the most important points is the need for diversification in funding sources. 88% of SVB's deposits were unsecured corporate deposits, compared to 16% in the banking sector in Europe. They had huge concentration risk, in addition to the tech sector. Diversification of funding sources is going to be a critical component to the way the banking sector takes forward risk and evaluates portfolios. In the wake of SVB and First Republic, there was huge utilisation of the Fed window. In the United States during the financial crisis in 2009, about $115 billion was used. In the week after SVB, it was $165 billion. The European Central Bank (ECB) and the UK have active windows, which remains critical for the banking sector to regain its footing after something happens. Banks will have to think a lot harder about digitalisation. Credit Suisse ended the year with about $56 billion of cash on its balance sheet. It lost $50 billion in a matter of five days. That was at the core of the bank being married with UBS.

1.3.3 Confidence and systemicity at the digital age

An official stated that the combination of social media and mobile banking presents a challenge for institutions, which manifested in the $42 billion run for SVB in a few hours. Speed is of the essence but there is need to be realistic on what can be achieved, as well as what needs to be done and how to bridge that gap. It is also known that dragging moments happen, and there is need to act decisively, quickly and to be flexible when action is required. One of the lessons is that both US and Swiss authorities reacted within hours, in a swift and coordinated manner. Many think that the AT1 markets left a few strings loose, such as the specific definition of what systemic is. Linking that to the social media argument, everything is informationally systemic.

1.3.4 The nature of sovereign bonds as "risk free assets" raises questions

An industry representative noted that a great deal of interest risk was coming from sovereign bonds. Years ago, a bank finding itself in trouble because of holding too much sovereign bonds was strange. From the supervisory point of view, the system has as an important 'risk-free asset' in sovereign government debt. The fact that during a crisis this can be a problem instead of a solution means there needs to be a rethink of what it means for the prudential framework. On the liability side, something new has happened in that deposits are legally in demand and so are short, but in practice have been considered sticky, except during a panic.

1.3.5 Anticipating crises remains challenging

An official stated that economists are not good at anticipating crises but may be good at explaining them ex-post. The question is why because economists are always trying to identify risks everywhere. It might be a matter of not putting the exact likelihood of the risks. There may be a component avoiding a self-fulfilment in the identification of risks.

2. EU priorities for the financial industry in the current challenging macro environment

2.1 Opportunities and challenges for the financial sector in the current macro-economic environment

2.1.1 Inflation is not a good deal for banking and finance

The Chair wondered whether the main threat from over indebtedness comes from higher financing costs. This is just one element of a much broader macro-financial context of high and persistent inflation combined with sluggish growth. Notably, real interest rates remain negative.

A public representative commented that there have been opportunities with the increase of interest rates for the financial and banking sector. There have also been threats and effects on balance sheets. There is need to be wary about inflation. Interest rates are the result of trying to cope with the high inflation. The problem is how to deal with that and the impact on the financial industry. In the medium and long term, inflation affects expectations and investment plans, because it creates uncertainty. One potential risk is that investors look more at the medium and short term, because they do not know the dynamics. This could affect investments in the medium and long term, affecting potential growth. In the past year, there has been the impression of too much reliance on the ECB and monetary policy. The same has been done more recently on inflation. The ECB has a key role, but it is a very complex phenomena and there are certain things that ECB and monetary policy alone cannot do.

2.1.2 The challenges and impacts for the financial sector

An industry representative highlighted that things are doing well in Europe in this environment. The question is how to manage assets in liabilities and interest rate risk. Loan deposit repricing is outpacing the increase in the deposit pricing. That is called beta, which is the reason banks in Europe are doing well. Their deposit rates are not reverting as fast as their ability to reprice their loan. The losers are Capital Markets businesses and mergers and acquisitions (M&A) businesses. 2022 saw wallets decline about 50%, and 20% in the first three months of 2023. Clients are waiting for a moderate business environment and ability to take decisive action to commence deals. The execution enclosure of transactions has softened. In some bank results, if they are heavily oriented towards markets or the investment banking businesses, they have had a harder year. It is still a benign credit environment. The one thing that could surprise is credit deterioration, partially because of the higher interest rate environment. It is important to keep eyes on managing assets and liability frameworks to make money.

One risk that cannot be quantified is quantitative easing being pulled back. The impact that is going to have on the banking system is not known, with liquidity effectively being withdrawn from the market. However, there could be pockets of liquidity weakness because of the monetary policy being unwound. On a positive note, the outlook for economics in the EU has been upgraded. Southern Europe was one of the reasons that Europe recovered better last year and had a better economic outcome. Europe is not in crisis, but Switzerland and the United States have been. There is still a lot of work to do on banking unions and capital markets unions (CMUs), not waiting for the crisis.

2.2 More equity financing and less debt financing is the right way forward

The Chair commented that US and Swiss banking sector developments are an example of how the financial sector has been caught out by the abrupt paradigm shift, which is not only relevant for banks. Much of the international economy has drifted into a financialisation trap, where over indebtedness has become a constraint on the investment needed to boost productivity and deliver long-term growth.

A Central Bank official noted when inflation and interest rates go up, typically the financing conditions tighten. Deglobalisation is also playing a role. For the financing in general and financing of enterprises, this will have an impact. For emerging economies with higher inflation and higher interest rates, this might constitute a much higher impediment. With regard to Europe, this will not be a decisive factor, but this challenge should be used as an opportunity to put more emphasis in the future on equity financing instead of debt financing. The analysis of CMU's specific issues and the study of the supply of and demand for equity funding, as well as the governance structure would allow the CMU question to be put to rest.

With regards to central banks and from an economic point of view, it is important to think more about equity in an economy. The first part is to look how enterprises and corporates are financed in the US and Europe. In the US, the corporate financing happens to roughly 25% with debt and 75% with equity via capital markets. In Europe, there is roughly 25% of equity and 75% debt financing for the corporate sector; and this creates a challenge for central bank policy. With a deep capital market, from a central banker's point of view, this implies less reliance on government public finance in order to deal with asymmetric shock in a currency union, such as the Euro area. US estimates suggest that more than 50% of the shocks can be absorbed by capital market flows.

Also looking at the most recent estimates, there is a role of equity financing instead of debt financing to deal with green transition. Equity financing is much more effective with regards to getting green measures across compared to the banking system and monitoring it.

Equity financing is also much better in bringing to life the so-called creative destruction by Schumpeter to boost productivity. One of the main reasons why productivity is so low in Europe compared to the US has to do with the lack of risk capital in the form of equity financing. In Europe R-star, the equilibrium real interest rate, is negative territory. In the US, it is still in the positive territory. If R-star cannot get back into positive territory, once inflation is back at the 2% target, it might be necessary to go back to unconventional monetary policy in the course of a monetary policy cycle.

In order to have an effective, efficient and deep capital market, there is need of capitalists (e.g. in the form of pension funds that cover much of the population). A capital market cannot be created simply by government regulation.

2.3 Coordination among central banks at the international level, coordination between fiscal and monetary policy and coordination within the Union are essential to address the challenging economic outlook

A public representative stated that coordination needs to improve. A coordinated effort has to be made to keep inflation down. Different types of coordination need to be considered. First is coordination among central banks in different jurisdictions. When all the major central banks raise the internal rates simultaneously, it could have a more negative impact on the GDP and the growth potential. The effect on inflation can also be weaker because the foreign exchange channel is less effective.

The second type is coordination between fiscal and monetary policies. Not enough has been done, especially in Europe. This is very challenging, because there is one monetary policy but 27 different fiscal and economic policies. All the countries tried to be coordinated, in not giving room for a wage spiral and coping with the high inflation for lower income, by providing some support at the national level so salaries did not have to be renegotiated. However, inflation was not temporary. A more coordinated effort needs to be found. It is also a double issue, with the profit spiral. This is not so much a monetary problem as a distributional issue.

The European Union needs to be credible and intervene in a way that does not slow the economy too much. More coordination would be needed among central banks and the fiscal policies across jurisdictions, Waiting for the ECB to solve the inflation will end up creating more problems. Finally, coordination is important on a broader international level, in particular with regard to the Inflation Reduction Act (IRA) adopted in the US and other measures that might have the effect of trade barriers or incentives to delocalise Europe's renewable energy industry.

2.4 Improving the EU crisis management framework

An official raised that officials have to try to learn from others' experiences and crises, and to reinforce the ambition on the regulatory agenda, not only pushing with the crisis management and deposit insurance framework (CMDI). Working from the legislative proposal provided by the Commission and a clean implementation of Basel III are needed. Public decision makers have to go further and take pieces of these new lessons. Liquidity before, during and after resolution. We need to rethink how to act and take into account the figures of the liquidity needed for Credit Suisse in comparison with what is within the SRF. This is linked to confidence as well, which is particularly important in a world where liquidity is more liquid than ever. There are also further steps that are pending beyond CMDI. Keeping the work on addressing the vulnerabilities of non-banking financial institutions is also important. The last lesson is to explore whether other regulatory improvements are still necessary. There might be even less time to react.

An IFI representative noted that each constituency has its own regulatory regime, but all decisions are interpreted by investors at a global level. What happened in Switzerland on the treatment of Credit Suisse's AT1s was specific to the situation but had a global impact on the AT1 market and the assessment and the pricing of its risks. The decision taken on the crisis management deposit guarantee scheme had also repercussions. This should call for increased cooperation at the global level, for example to give a common definition of what a systemic bank is.

There was a great deal of work put in on how to deal with systemic banks and the resolution. In the US, there are eight banking groups, which have the total loss-absorbing capacity (TLAC), when in Europe there are 115 groups subject to the direct supervision of the ECB. They are very different approaches with the same tools. One of the big questions moving forward is what the resolution framework is, how to preserve its credibility, and in particular the assessment of what a systemic institution is.

2.5 The case for a European financial strategic autonomy is more relevant than ever

An official stated that geopolitics is leading to fragmentation. We should also look at the figures because trade is still growing. Trade between the US and China is growing. Trade between Europe and China is growing. Europe has done a good job in this environment: dealing with the energy crisis by rebalancing the energy supply in a very short time, increasing different spending, showing solidarity with Ukraine and taking action to deal with the global challenges of green transition. To increase strategic autonomy, there is need to deal with human capital and put more people to work. That is the reason for the pension reform in France. There is a need to look at capital, and more equity is needed and less debt. In the CMU there is an alphabet soup of EMEA, Markets in Financial Instruments Regulation (MiFIR), European Long Term Investment Fund (ELTIF) and risk, but the European Commission are pushing this with a great deal of resolve and determination. A deeper capital market will be created in Europe.

There is progress on digital euro and investing in sectors to be more resilient, with green tech and sectors in which Europe wants to be more independent. The European Union will continue to trade, but in sectors such as batteries, chips, hydrogen, solar panels and electric vehicles (EVs), more independence is needed.

2.5.1 Autonomy means building resilience in the EU financial markets

A public representative stated that strategic autonomy is not the same as protection. The two things sometimes get confused: that to be strategically autonomous Europe needs to close. This is the wrong way of achieving autonomy.

Autonomy should also not be an objective in itself. The objective is the resilience. In physical supply chains, autonomy when there are physical disruptions could be good for resilience. There could be sectors where autonomy is not the best way to achieve resilience. Openness, scale or regulation might be the best way. If there is a threat to resilience, it could be a physical or it could be a non-material like cyber-attacks. This has to affect the response and how resilience is built more than autonomy. One thing is regulation and international standards, because it is a highly interconnected market and infrastructure. It is very difficult to stop that from being international. It is a strength, not a weakness, but needs to be regulated. The only thing that Europeans can do is to have the CMU to build resilience in the financial market.

2.5.2 The security and the diversification of supply needs to be taken into account in the financial area

An IFI representative stated that Covid and the energy crisis triggered by the war on Ukraine have revived the issue of security of supply. With globalisation, the world had largely lost sight of the importance of ensuring security of supply and a proper diversification of supply-chains, which now more than ever prove to be key for stability in trade and in economic development. For the financial sector, this issue relates particularly to clearing services and the understanding that overdependence of EU financial institutions to a single foreign financial centre can pose acute security and stability problems. It does not mean that we should move from globalisation to fragmentation. But diversification of supply needs to be taken into account.

2.5.3 Applying the strategic autonomy objectives in the financial sector should be handled with care

The Chair noted that the system seems to be moving towards a partial de-globalisation. The policy actions of the United States, China and the EU are resulting in a fragmentation of the system.

An industry representative agreed there is a link between de-globalisation and inflation. Central banks are trying to curb inflation, which is resilient and will have to be dealt with for months, if not years. Part of the job that interest rates was done in the past by the structural deflationary input of international trade through globalisation. That deflationary element will disappear if movement remains in the opposite direction.

When talking about countries about strategic autonomy, the problem is what is meant by strategic autonomy. There are certain sectors that are too important not to be able to rely on in any circumstance. For some industries, it is right to have policy that ensures that international trade does not need to be relied on under any circumstances. There are times where, if international trade does not work, there needs to be access to certain products and services. The right way of approaching it is sector-by-sector. Then the big question is where financial market fits within this definition of strategic autonomy.

There needs to be care with financial markets because it is a network. Each institution cannot operate by itself. All institutions need to be fully integrated through the proper supervision. There are the authorities which are essential cornerstones. The strength and the ability to provide service efficiently does not depend on an institution itself. It depends how the market works, how deep they are and how well regulated they are. A financial market needs to be open and well regulated, with common standards, but with more institutions well connected with each other across Europe and across the world. That point has not been reached because not everyone has the same objective.

When talking about strategic autonomy, the best interests of financial markets Europe and in the US are to be well-connected and well-regulated together. There is always suspicion that all non-EU banks retreat to its own constituency when tough times. However, recent experiences like Covid say the opposite. JPMorgan, for instance, increased lending in Europe by 20%. Rathan than retreating, the participation of global firms in the EU system brings added competition and market depth. The reliance is not on the institutions but on institutions and the market network.

2.6 Closing the financial files by the end of the EU legislature

An official liked that the starting point is a positive and optimistic one. The good health of the financial sector is a good sign. The worst scenarios are not materialising as expected. Everyone is aware of the challenges being faced. Central bankers coordinate better than policymakers or fiscal authorities. At the same time, everyone is in recovery mode but has to start generating fiscal buffers and making good on investment commitments. This poses challenges and a holistic approach is needed, but there are tools to do it. Europe has many important files coming to maturity over the next few months and needs to engage in closing those files with this holistic approach. Not all of them have to be financial. The energy market reform and structural reforms related to the energy market are key to ease the trade-off between the monetary and fiscal policy in terms of taming inflation. On the financial side, there are investment needs going forward. This is what will ensure resilience. All potential sources of funding need to be unlocked and made good on.

The opportunity coming from Next Generation EU funds and associates has to be seized and made a success. There is need to ensure that investment is not a victim of consolidation processes. Quality spending is important. Then public decision makers have to push further with the CMU. Integration of financial markets is of the essence because it leads to more competition. There can be a discussion on whether the betas for the deposits are optimal or not. Then there is reinforcing of payment systems for increasing autonomy, including the work on the digital euro and the anti-money laundering package, which includes elements like financial intelligence and cooperation around financial intelligence.

The Chair stated that this is a very challenging and dangerous macro-financial context, as it has shifted from the paradigm of "low-for-long' interest rates to much higher interest rates. Evidence suggests that the EU is not seriously affected. However, the big question is to decide is whether SVB and Credit Suisse were idiosyncratic cases, or "canaries in the coal mine". The CMU must happen., There is now a geopolitical overlay on what was a very globalised economic system, and it does not fit so well. While there is a risk of de-globalisation, the more likely outcome is a re-globalisation, reflecting this geopolitical overlay. Economic security now has renewed importance, but it is difficult to manage in the financial sector without significant fragmentation costs because of network effects. Open strategic autonomy is the way to go.