FINANCIAL STABILITY RISKS IN EUROPE

FERNANDO RESTOY
Chair - Financial Stability Institute (FSI)

Recent bank failures, deposit stability and the role of supervision

Over the years, an evolving policy framework composed of partial deposit insurance coverage, a prudential regulatory and supervisory regime and a banks' failure management system have been used to contain the risks associated to destabilising bank runs. Recent bank failures may point to a structurally less stable banks' deposit base as a consequence of technological developments. That might eventually justify the consideration of some reforms on different aspects of the policy framework aiming at further protecting financial stability. Those reforms should in any case be grounded on compelling evidence and, crucially, on a rigorous cost-benefit analysis.

For the time being, though, those episodes already constitute a good case for speeding up a full implementation of the Basel standards in all jurisdictions. Moreover, they support the need to put in place or further develop pragmatic bank failure management regimes -such as the one contained on EC's CMDI proposal - that sufficiently acknowledge the need to provide non-insured deposits with a sensible degree of protection when banks fail.

But, even more importantly, supervision should be further strengthened to address the root causes of bank failures. Indeed, while the case for radical regulatory reforms still remains quite uncertain, there are already clear arguments for reviewing supervisory practices and seeking ways to strengthen them. For example, the materialisation of interest rate risks triggered several bank failures. But banks' vulnerabilities unveiled by those failures went beyond specific exposures or funding sources. This included excessively risky balance sheet structure, deficient risk management and unsound growth strategies. In other words, the root cause of the weaknesses of failing banks was a flawed business model and poor governance.

Of course, the large amount of non-insured deposits accelerated the failure, but this was not the main vulnerability of the failing banks. Put differently, the assumption that non-insured deposits are now less stable than in the past should primarily lead to the conclusion that more and earlier policy action is needed to promote sustainable business models and sound governance practices.

Importantly, the ability of standard prudential rules to address this type of weakness is limited. There is simply no feasible amount of capital and liquidity requirements than can compensate for banks with poor governance or business models. To the contrary, an attempt by authorities to compensate for a bank's structural deficiencies with more capital and liquidity could well exacerbate problems and further undermine the viability of the institution.

Actually, the prompt identification and correction of those deficiencies is the core business of supervision. The European banking union is a good example of a jurisdiction which has developed a well-structured supervisory review and evaluation process (the SREP) which supports the application of Basel's pillar 2. In particular, unlike other jurisdictions, together with capital and liquidity adequacy, the ECB's SREP evaluates the governance and business model sustainability of all banks under its remit. On the basis of that evaluation, it regularly conveys recommendations or requirements to banks in order for them to address their weak points. In a recent report commissioned by the ECB, a group of experts have praised this structure, although we have also recommended that the approaches followed when deploying qualitative measures be further improved by refining their formulation, prioritisation, and monitoring.[1]

Before considering far-reaching regulatory reforms, give supervision a chance.

More broadly, supervision can become more effective with a more forward-looking and intrusive approach. Authorities should have the means, powers and culture to challenge more forcefully banks' business plans, internal organisations and decision-making processes without, obviously, alleviating any management responsibility. Before we even think of introducing far-reaching changes in prudential rules or in the scope for deposit guarantees, we should first give supervision another chance.

1. *Dahlgren S, R Himino, F Restoy and C Rogers (2023). "Independent Expert Group Report on the SREP", ECB, April.*

YANNIS STOURNARAS
Governor - Bank of Greece

Cutting the Gordian Knot: financial stability in turbulent times

Issues around financial stability and the interplay with monetary policy came into the spotlight, following the recent banking turmoil. In fact, many analysts claim that today authorities are facing a new economic trilemma, as we cannot achieve price stability, maintain economic growth, and have financial stability at the same time.

Over the past few years, we experienced several fat-tail events or adverse shocks, such as the pandemic, the Russian invasion of Ukraine, the energy crisis, the turmoil in the UK Gilt market and in the US banking sector. The EU banking system managed to weather all these adverse events on the back of solid financial fundamentals that were gradually built up after the Global Financial Crisis.

At the same time, EU banks do not share the vulnerabilities of some failed US banks. These cases were rather idiosyncratic and related to significant weaknesses in the risk management (especially regarding interest rate and liquidity risks) as well as the inadequate internal control systems of these banks, which were exposed by the tightening of the monetary policy.

Nevertheless, risks to financial stability have been rising over the past few months due to uncertain macroeconomic outlook amid high geopolitical risks, the sharp increase in interest rates and the persistently high inflation which could amplify pre-existing vulnerabilities in the financial sector. Strains on balance sheet of non-financial corporates and households could impair asset quality of EU lenders. Prospects for banks could also deteriorate, as the reassessment of economic growth prospects alongside with rising interest rates will probably weigh negatively on the demand for new loans, the cost of funding and the implementation of banks' business plans. Risks stemming from exposures in the non-bank financial sector (NBFI) and the CRE market could also materialize.

Finally, other cross-cutting risks such as the climate change risk and the risks stemming from cyber-attacks have recently gained importance.

The recent episodes in the US banking sector, was a powerful reminder that a crisis can unravel very fast upon the loss of market and depositors' confidence. Therefore, there is no room for complacency. So how will policy makers ensure the preservation of financial stability amid tightening monetary policy? Some high-level proposals could include a) the improvement of the regulatory framework for the non-bank financial sector, b) the use of macroprudential policy with the aim to increase resilience in the system, c) the implementation of top-quality supervisory standards, levering on the lessons learnt from the recent turmoil, and d) the improvement of our crisis management framework and the completion of the Banking Union.

There is an Ancient Greek legend associated with Alexander the Great in Gordium of Phrygia, regarding a complex knot that tied an oxcart. Reputedly, whoever could untie it would be destined to rule all of Asia. In 333 BC Alexander was challenged to untie the knot. Instead of untangling it laboriously as expected, he dramatically cut through it with his sword[1]. Today, policy makers do face an equivalent challenge in the form of the 'new economic trilemma'. However, we know that authorities cannot address such a trilemma with one tool alone, like Alexander the Great did with his sword; instead, there is a role to play for all stakeholders, i.e., monetary (and fiscal) authorities, as well as banking supervisors and macroprudential authorities.

Financial stability in turbulent times: what are the implications for policy makers.

Even though the monetary policy and financial stability tools are used on a standalone basis to address different purposes, they both have an impact on the economy and the economic agents and are interconnected. Therefore, monetary authorities should continue to pursue their goal and take well-informed decisions to address the inflation problem while supervisory authorities (and banks' management) should ensure the resilience of the financial sector. At the same time, we should follow Alexander's example and take bold and decisive actions to address the structural challenges we are currently facing. In the euro-area, on top of our list with actions should be the completion of the Banking Union and the further integration within our fragmented banking sector.

The completion of the Banking Union will remove for good the bank-sovereign nexus and shield the European banking sector from many external and domestic shocks.

1. *https://en.wikipedia.org/wiki/Gordian_Knot*

ANDY BLOCKER
Global Public Policy - Invesco

The framework for liquidity risk management in OEFs must be robust yet flexible

Over the last few years, there has been a flurry of activity from policymakers globally seeking to map and address potential risks stemming from the so-called 'non-bank' sector and, though some of the debate has suffered from a lack of precision regarding the scope of the sector and, as a result, evidence of globally systemic risks that may materialise therein, the progress which has been made by the FSB and IOSCO in publishing their respective recommendations on liquidity risk management (LRM) in OEFs should be acknowledged.

It is also important to acknowledge the principles on which the recommendations are made including ensuring that the dealing profile of a fund reflects the liquidity profile of the underlying assets; that the cost of liquidity is borne by subscribing or redeeming investors; that existing or remaining investors in the fund are protected from material dilution; and that disclosures appropriately inform investors about liquidity risks and the framework in place to protect them.

It is critical that the broad principles-based framework for LRM in OEFs, while robust, is sufficiently flexible so as to be reflective of the practical realities of managing such funds in different jurisdictions. Indeed, it must be able to accommodate diverse market practices, operating, distribution, and dealing models. As an example, this means that while swing pricing might be relevant for Europe, it is not appropriate for the U.S. given inherent differences in both markets. In this regard, we welcome the recommendation that local regulators make a broad LRM toolkit available for use by asset managers as most appropriate for their respective markets.

This need for flexibility reflects authorities' shared belief with industry that there is no "one-size-fits-all" approach to LRM, and that asset managers are best placed to manage liquidity within their portfolios in the best interests of their investors. In its proposal related to liquidity bucketing, the FSB, in our view, risks undermining this key policymaking tenet by being overly prescriptive in seeking to ascribe particular dealing structures to specific asset classes based on their perceived liquidity which, as we know, is dynamic and reflective of market conditions. The calibration of such a policy, if pursued, should not preclude end-investors from accessing investment opportunities in specific assets classes deemed 'less liquid' via OEFs where appropriate LRM mechanisms are in place.

This, of course, relies on effective governance and oversight from fund boards and other relevant governing bodies tasked with implementing and overseeing OEFs' LRM activities, as well as disclosing to investors the protections they are afforded by the LRM framework.

While governance and disclosure are well covered in the recommendations, it is unfortunate that, in the case of authorised OEFs, neither authority sufficiently takes account of the work undertaken by asset managers in relation to a fund's LRM framework leading up to and at the point of authorisation which involves agreeing with their local regulator the appropriateness of a proposed fund structure, the investment and distribution strategies to be pursued, and the LRM framework to be implemented. Indeed, liquidity risk analysis also forms part of managers' fundamental investment processes, and this should at least be acknowledged as part of an OEF's broader LRM activities.

Additionally, it is vital that policymakers give due consideration to practical barriers to the implementation of certain LRM tools, and we welcome IOSCO's attempt to provide solutions to issues relating to the reliability of market data, and the role of third parties in operationalising such tools. Overcoming such barriers will be key to enhancing OEFs' already well-developed investor protection and LRM frameworks.

The framework must accommodate diverse market practices, operating, distribution, and dealing models.

Finally, authorities must better address the cost of their recommendations, to local regulators, firms, and end-investors, by undertaking robust cost benefit and impact analyses. OEFs, and non-bank financial products more broadly, are critical to wealth creation. They are highly regulated and transparent, and policymakers must acknowledge that it is neither prudent nor feasible to seek to regulate risk out of the market entirely, unless the policy objective is to see end-investors' opportunities diminish.

Our role as an asset manager is, first and foremost, as a fiduciary to our clients, but it is incumbent on all stakeholders, including policymakers and regulators, to ensure that the regulatory and supervisory environment in which we operate is robust but also conducive to creating value for investors.