Financial stability risks in Europe

The Chair stated that although financial stability risks are currently under control, the question is how long that will remain the case. The panel will consider the main risks and vulnerabilities, first in the banking sector and then in the non-bank sector.

1. Financial stability impacts of the current monetary and economic environment

1.1 The macro-economic environment of persistent high inflation and low growth

A regulator pointed out to the strong bank performance in Europe over the last months. Also, the recent results of the stress tests have hinted at stronger resilience against an unprecedented adverse scenario. On the other hand, high bank profitability is high not because of structural reforms in the banking sector nor for the credit institutions' capacity to enter into new markets or launch better products, but because of the automatic widening of the net interest income (NII), which is due to changes in monetary policy conditions but has been also helped by the banks' slow response on the pricing of their liabilities, first and foremost their customers' deposits. This is a historically unprecedented case of inertia and perhaps even sleepiness. Certainly, credit quality has improved and the Single Supervisory Mechanism (SSM) has done its work. However, the buffer of NII profits will be eroded, making more difficult for banks to insulate from global adverse trends.

In fact, the economy is weakening, and inflation has remained high, while real GDP is expected to remain subdued in the coming months, having broadly stagnated over the first half of this year. Besides the overarching issue of tighter financial conditions, macroprudential authorities have pencilled many reasons of concern, like fragility in commercial real estate, and problems from lower growth in China and worsening trade fragmentation.

That raises some fundamental questions. How quick profitability will be reduced, also due to the already significant decreasing lending demand? What impact will rising interest rates have on asset valuation? Will deposit stickiness be preserved, or will new technologies erode the franchise value of banks?

1.2 Risks and vulnerabilities are sensitive to the tightening of financial conditions

1.2.1 Member state public indebtedness and the sovereign bank loop

A Central Bank official emphasised that financial stability is necessary for the smooth transmission of monetary policy. Central banks should be concerned with public debt issues, because they are part of the financial loop, and government bonds are in banks' portfolios. Public debt increased because of the pandemic and the energy sector problems, but it is falling back now despite the fact of still large primary budget deficits in certain member-states. The situation is indeed under control because of the so-called snowball effect: the difference between the nominal growth rate and the effective interest rate on public debt is positive because inflation goes high as GDP growth is positive. Despite interest rates rising because of the European Central Bank (ECB) activity, the average interest rate on public debt is still 1.7% in the eurozone. That has helped governments bring down the public debt to GDP ratio.

However, as monetary tightening has caused a general increase in interest rates and weaker growth, there is no room for complacency in fiscal policy. The average interest rate on public debt is expected to go up. That will impose strains in the public debt path. Moreover, the bank sovereign loop is still important and remains a supervisory concern. Regulatory reasons dictate it because banks use government bonds in their portfolio to satisfy liquidity coverage ratio needs, and also because there were large public deficits, so there was a great deal of issuance.

1.2.2 Keeping a restrictive fiscal stance

A Central Bank official stated that it is in everyone's interest to have a prudent fiscal policy that takes care of deficits and makes sure that public debt is falling. It would be imperative for the European Commission, the Eurogroup and the European leaders to agree on the new fiscal rules, since the old ones are characterized by inflexibility and pro-cyclicality. The balance sheet of the Eurosystem has shrunk a great deal, not because of outright asset sales but due to TLTRO redemptions and the pause in APP reinvestments.

1.2.3 Where the impact of higher rates could be felt

A Central Bank official noted that it is difficult to think about banks in isolation because banks' balance sheets reflect the balance sheets of the economy. The big story over the past 18 months has been that sharp transition to higher rates combined with greater market volatility. Large parts of the financial system and the economy have been resilient to the rate rises; the impact will take time to come through.

Part of the story for the system's resilience has been the regulatory measures put in place. The UK and Europe have capitalisation for interest rate risks in the banking book and high levels of bank capital. There are high levels of liquidity buffers and regular stress testing. What happened in March in the US is the impact of the higher rate environment on the banking sector starting

to flow through. There is higher NII for a while but not forever. It does impact and increase unrealised losses.

There is a long list of potential areas where the impact of higher rates and greater volatility could come through. Commercial real estate (CRE) is an obvious area. There are leverage loans as well. The slowdown in China and the geopolitical environment are also on the list.

The Chair noted that each market is very different in terms of CRE. The financing structures and tenors are different. However, the US, Sweden and Germany demonstrate an obvious shakeout. The question is whether these will be healthy shakeouts required after a boom phase, or will overshoot into the collapse of healthier vehicles, developers and players.

A Central Bank official added that there is a structural trend in the CRE sector. Some buildings are easily made more sustainable than others. There are shifts in demand patterns away from town centres. With stress, many of those structural issues are brought forward.

The Chair observed that due to the interest rate driven stress that all asset classes are subject to, plus office and retail in parts, there are structural factors, and in many jurisdictions, it is the end of a long boom phase, so there are exaggerations that were built up in recent years.

1.2.4 The benefits of the increased interest rates on banks profitability are transitionary

A Central Bank official stated that the tightening of monetary policy supports banks' profitability through net interest rates and related income, but this is not expected to continue. Although banks immediately priced the new interest rates on their lending rates, the beta on deposits is small, especially in the European south. This will not continue because depositors will try to find other outlets for their savings and the reduction of loan demand. Furthermore, access to capital markets and bond markets will be more expensive for minimum requirement for own funds and eligible liabilities (MREL) needs, so over time the net interest margin will fall and the funding costs will be higher. Hence, banks should be prepared for a more difficult banking and macroeconomic environment.

The Chair agreed that there will be a normalisation of interest margin, which was artificially low in the zero or negative interest rate environment. It might be artificially high now, and most banks probably know that if they do not reduce that margin themselves by treating their customers differently then somebody else will come and change their interest margin for them. The sustainability of that part of the profit and loss should not be projected into the long-term future.

1.2.5 Implementing Quantitative Tightening (QT)

A Central Bank official suggested that the place to start is pre-crisis, prior to quantitative easing (QE). What was learned from that period was that the level of reserves and liquidity in the banking system was too low. Central bank balance sheets expanded, and that partly addressed that issue. Central bank balance sheets will remain larger than they were pre-crisis for financial stability reasons.

The difficult question is what the end state looks like, in terms of the level of reserves needed in the system. That will depend on the future size and makeup of banks' liquidity buffers. Banks' liquidity buffers are a combination of reserves and high-quality liquid assets. If the right makeup is known then the right level of reserves can be targeted in response. Getting there involves thinking about implementing these strategies gradually, always taking into account financial stability.

The Chair added that there is a need for close coordination and information exchange between supervision and the monetary policy side of the central banks.

1.3 The relevance of the crisis earlier in the year to the full implementation of the Basel standards in all jurisdictions

A regulator noted that the international standards already contain a number of prudential controls for interest rate risk. For the marked-to-market portfolio, changes in interest rates affecting asset valuations are reflected in both the accounting and regulatory capital frameworks. More problematic is the treatment of interest rates in the banking book. The international standards prescribe that this should be dealt with under Pillar 2.

The potential controls were not effectively applied in the case of the US during or before the turmoil. Silicon Valley Bank (SVB) and other regional banks in the US are not subject to the Basel standards, and the applicable prudential regime implied that some unrealised capital losses in the marked-to-market portfolio, while recognised in accounting income, would not be deducted from regulatory capital. That is a very odd situation under which the accounting regime is more prudent than the prudential regime. In addition, there is no articulation of Pillar 2 in the US. Therefore, interest-rate risk in the banking book is not subject to specific prudential controls, such as capital add-ons.

The situation in Europe is much more robust, especially because of the application of both Pillar 1 and Pillar 2 to basically all banks. The developments in the US have shown that the increase in interest rates has unveiled clear vulnerabilities in the business models of some regional banks. Those banks were running unsustainable business models characterised by excessive risk concentration on the asset side, excessive dependence on unstable sources of funding on the liability side, and excessive maturity transformation.

1.4 More effective, forward-looking and intrusive supervision

A regulator remarked that there is no capital or liquidity that could compensate for an unsustainable business model. Intrusive supervision is needed. The framework in the EU is quite robust. Within the Supervisory Review and Evaluation Process (SREP) process there are specific chapters for interest rate risk in the banking book and for business model sustainability.

In general, the first priority of most banking authorities around the globe should be to strengthen supervision. Supervisors need to have the powers, tools and culture required to effectively challenge the business model,

governance structure and risk management procedures by financial institutions.

The Chair agreed about the need for a combination of regulation, supervision and bank risk management. The lesson from the US regional banks is that if a bank does not have this correctly on its radar and under control, and if the regulator or supervisor is not on it then this risk category can take banks down very quickly.

An industry representative observed that Europe has been very pragmatic. It has had data driven, collaborative engagement with industry and those impacted by its decisions. Interest rate hikes do not necessarily cause holes in the system, but they can but reveal them. SVB and other incidents revealed what all have acknowledged were supervisory failures.

2. Assessing and addressing risks in non-bank financial intermediation (NBFI)

2.1 Ongoing work to enhance NBFI resilience

The Chair stated that the distribution of risk throughout the non-bank sector in comparison to the setup prior to the financial crisis is risk reducing, because of that dispersion, but there is a danger of blowback into other parts of the financial system. The risk has been moved into less transparent parts of the system.

A regulator explained that asset managers are trying to adapt to the abrupt end of low-for-long. On the other end, an entire generation of asset managers has never experienced interest rates this high, nor macro conditions with inflation like currently. Are they going to be able to manage risks appropriately? Bond funds are reducing the duration of their portfolios, which is per se welcome. Also average portfolio maturity for money market funds (MMF) dropped sharply in 2022, while now is fluctuating.

A few risks have to be controlled, first and foremost credit risk. The credit quality of portfolios exposed to certain categories with lower credit standards has now deteriorated to a five-year low. The capacity of markets to exercise foresight on incidents is also limited: for example, with Archegos it was not just macroprudential authorities that were surprised. Banks did not even know size and complexity of their exposures. Finally, dramatic developments like those with liability driven investments (LDI) also pointed out to the serious adverse impact of domestic political risk.

Turning to commercial real estate, real estate investment funds are often even more important than banks, in terms of support they provide to market participants via alternative lending. Counterparts are exposed to high volatility in valuation.

On the other end, some measures have been taken. Recently, EU authorities reached an agreement on the review of Alternative Investment Fund Managers Directive (AIFMD) and undertaking for collective investment in transferable securities (UCITS). This contains a strengthening of liquidity management tools. Previously the only available tool was 'institutionally charged' possibility for suspensions: now, there are 10 tools. Each alternative fund manager will have to choose at least two of them. The European Securities and Markets Authority (ESMA) has been given an important implementing mission.

The Chair noted that with the LDI there was the NBFI moment in the UK, which showed that when talking about margin call risk, hidden leverage or underestimated leverage risks there is something there.

2.2 A system-wide perspective to address risks to financial stability

A Central Bank official noted that the Financial Policy Committee put in place a resilience standard for LDI. This provided some helpful pointers for how to think about building better resilience in the non-bank sector. There is not likely to be a single macroprudential tool to address some of the risks in the NBFI sector. The role of firms within market-based finance and interconnections between them can change through time and often quite quickly. Monitoring and being able to stay on top of some of these issues is crucial in this sector because it is not necessarily a slow-moving risk.

In terms of identifying risks a broad approach is needed. Weakness in a business model or a type of product if well managed may, in and of itself, probably not be an issue. It is a risk that needs to be managed and mitigated. However, when it interacts in the context of a market or a stress, it can be an amplifier. With the LDI experience, weaknesses in business models in a relatively concentrated market combined to risk causing real economy impacts.

One approach being taken to improve the ability to spot those risks is a system-wide exploratory scenario (SWES). It is focusing on a number of core UK financial markets. Specifically, gilts, gilt repo, sterling corporate bonds and a number of associated derivative markets; this involves 50 market participants (banks and non-banks) in the UK aiming to reflect both activity and diversity in those markets. The idea is to model a stress with these participants to see where the strains and weaknesses appear, where liquidity flows to, and where it does not, and to see how to think about these risks in a system-wide way. This reflects a macroprudential and system-wide focus – and a desire to better understand market resilience rather than individual firm resilience.

2.3 The European approach to MMFs

The Chair stated that the MMF sector has served as a systemic risk accelerator at least twice recently. An industry representative highlighted the need to talk about non-bank financial intermediaries. Asset management there is extremely well-regulated, extremely transparent and extremely resilient. It has very proven risk management tools that it uses on a consistent basis. It partners with regulators who help and provide even more tools.

With respect to MMFs, Europeans should be applauded for their approach. A number of real-life stress tests have been withstood. Whether it is specific to MMFs, or

even more in open-ended funds longer term, it should be ensured that sectors that have actually proven that they have been resilient through real-life stress tests are not gone after. Central bankers and regulators have an obligation to investigate and identify the dangers there are. If they see something, they have to assess the threat. However, their first instinct should not be to kill the sector. It should be to identify what the data demonstrates and then to act appropriately.

The Chair challenged the observation that MMFs have always been resilient. There have been a couple of episodes where they were only resilient because there was a market maker of last resort from the central bank community. The aim is to avoid that happen again by finding the right tools. An industry representative emphasised that it is not always possible to solve for the 0.1% exogenous event. Central banks are seen as the lender of last resort that save the industry when things are out of the ordinary.

The Chair remarked that the concern is around the moral hazard that comes with the idea that there are market makers of last resort. When considering what has happened in the non-bank markets, and the risks that have crystallised, crypto, energy and commodity markets can be looked at.

2.4 The interaction between non-financial intermediaries and the traditional financial system

A regulator noted that there have been some recommendations by the Financial Stability Board (FSB) on how to improve the regulation of the MMF market. First is trying to mitigate the role that MMFs could play in accelerating problems due to liquidity mismatches, leverage and so on. A sector-by-sector approach is helpful, but a comprehensive framework to understand how different players interact in creating and accelerating financial instability is preferable.

The most urgent area for the regulatory and supervisory community is around the interaction between the non-financial intermediaries and the traditional financial system. The problem with Archegos was not Archegos itself but its links with some traditional financial institutions, including Credit Suisse. Banks are quite exposed to NBFIs. They provide liquidity facilities, investment opportunities and prime broker services; they also facilitate access to centralised clearing and act as a counterpart in derivative transactions.

Therefore, although the growth on NBFIs has implied a transfer of business from traditional banks to NBFIs, the risks have not disappeared. Banks are still indirectly exposed to the same risks through their exposure to the NBFIs. Those linkages between the traditional banking system and the NBFIs are concentrated on a few entities. ECB data shows that in the banking union there are 11 significant institutions with 80% of those linkages on the asset and liability sides. Those interconnections can be a cause of financial instability, so the regulatory and supervisory framework may need to be adjusted to be able to deal with them.

The Chair suggested that parts of the sector are more difficult to make visible to understand the connections, but the interface back into the banking system is one that banking supervisors are tasked with seeing. The Archegos episode shows the risk management is not adequate. It can very quickly spiral into something extremely damaging.

2.5 Addressing the structural change in the financial system

A Central Bank official stated that the non-bank financial sector, including MMFs, hedge funds, private equity funds, asset management companies, insurance companies and pension funds, has in general behaved rather well despite the multiplicity of shocks in recent years. Banks outside of the remit of eurozone supervision, such as SVB or Credit Suisse, had problems. The work of the SSM should be praised. It has managed banks quite well and has eliminated the national bias from the supervision of banks.

However higher interest rates, low growth and demanding market valuations provide reasons for concern, particularly given the various exposures of banks to non-banks. The policy framework has to be completed and the sector made more resilient.

Supervisors and regulators of non-bank financial institutions should strengthen their rules, especially regarding governance, liquidity mismatches and capital adequacy. For instance, the same governance required of banks should be required of the non-banking financial sector. Excessive exposure to commercial real estate and retail real estate could be dealt with through borrowed based measures and macroprudential buffers. The April 2023 crisis management/deposit insurance proposals of the European Commission should proceed without delay as a step in the completion of the Banking Union in Europe.

All supervisors should increase their coordination, cooperation and exchange of information. Supervisors should enjoy independence and respect in the exercise of their duties, as well as have adequate resources. The SSM has been successful in the supervision of European banks and should be used as an example in other jurisdictions. Enhanced cooperation is also needed between banking supervisors, capital market committees, bond supervisors and capital market supervisors.