Key macro and micro risks

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Containing risks in non-bank finance – the role of macroprudential policies

Much progress has been made internationally over the past ten years in improving the systemic risk monitoring of the nonbank financial sector. The types of shadow banking activities that were most closely associated with the buildup of vulnerabilities prior to the Global Financial Crisis have been curtailed. The development of a macroprudential perspective and the creation of macroprudential authorities in many countries has contributed to a more holistic assessment of risks in the financial system, including the nonbank sector. Under the leadership of the FSB, the size and growth of the shadow banking sector worldwide are now regularly measured, and the main risks are being identified. At the IMF, the Global Financial Stability Report (GFSR) now regularly provides a quantitative assessment of the degree to which future GDP growth faces downside risks from financial vulnerabilities, using a Growth-at-Risk framework. Advances have also been made in containing these risks, although much remains to be done.

> *"Although progress has been made in improving the systemic risk monitoring of nonbank finance, much remains to be done to contain risks."*
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> \- GASTON GELOS

Specific progress has been made on various fronts. In response to the crisis experience, regulations for securitization have been reformed, requiring some risk retention by the originating banks. Regarding insurance companies, solvency and regulatory frameworks have been improved in various jurisdictions (most notably, through implementation of Solvency II in the EU), but a globally consistent approach is still under development. To address concerns about risk management and transparency in OTC derivatives markets, much of OTC derivative trading has been moved to central counterparties (CCPs) and reporting to trade repositories. Since, as a result, many CCPs are now systemic, their financial buffers and liquidity support have been strengthened.

Potential risks associated with the worldwide growth of investment funds are slowly being tackled. The share of so called "other financial intermediaries", in

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>>> particular investment funds, has been growing fast (FSB, 2019). IOSCO has developed recommendations to address liquidity mismatches between the investments by mutual funds and their redemption terms. The standard setter has also published recommendations on leverage within investment funds, operational risk, and on securities lending. However, while some countries have adopted measures along these lines, generally regulatory advances remain limited so far. Data gaps continue to pose challenges. For example, available information on leverage among funds is usually limited.

Still, the continued growth of nonbank finance requires further efforts to properly monitor risks and react appropriately through supervision and regulation. Closing data gaps is key in this regard. Entity-based regulation needs to be complemented more systematically with activity-based regulation to avoid the migration of risks across entities.

The macroprudential toolkit will likely need to be expanded to better address risks related to the buildup of corporate debt from nonbank finance. For example, many companies, including in emerging markets, have increased their leverage through bond financing. Nonbanks have in recent years increased their exposure in the leveraged loan market. However, most macroprudential tools that have been adopted so far are aimed a banking activities, but containing risks related to the growth of nonbank debt may require tackling either these nonbank lenders or activities and/or the adoption borrower-based measures (ESRB 2018). In some jurisdictions, however, this may face legal and institutional obstacles.

Moreover, more thought may need to be given on how to regulate the build-up of leverage in financial markets. The FSB has issued minimum standards for margins and haircuts in securities lending markets (including repos). However, there is ongoing debate on whether it would make sense for macroprudential policymakers to regulate such margins more actively and in an explicitly countercyclical manner (Constancio 2016).

Lastly, international cooperation in these areas is highly desirable, given the potential for (positive or negative) spillovers, leakages, and migration of activities resulting from the adoption of macroprudential policies at the national level. ●

References: Constancio, Vitor, 2016, "Margins and haircuts as a macroprudential tool" remarks at the ESRB international conference on the macroprudential use of margins and haircuts, Frankfurt am Main, 6 June; ESRB, 2016, "Macroprudential Policy Beyond Banking: an ESRB strategy paper"; FSB, 2018, "Global Monitoring Report on Non-Bank Financial Intermediation 2018"; IMF, 2018, Global Financial Stability Report, "A Decade after the Global Financial Crisis: Are we Safer?".

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Global risks and European vulnerabilities

There is broad consensus across analysts that the major risks affecting the global economy are basically five: (i) geopolitical tensions; (ii) developments in trade policies; (iii) possible disorderly market developments following monetary normalisation; (iv) excessively high indebtedness, growth of leverage finance and other pockets of vulnerabilities; and (v) cyber- and other risks associated with technological innovation.

The global economy seems to be better prepared than in the past to cope with some of those risks. In particular, the general reduction of current account imbalances, the accumulation of reserves and the adoption of flexible exchange rates have made emerging market economies more resilient to external shocks. Moreover, the significant increase in the quantity and quality of capital in banks' balance sheets, following the international regulatory reform, make financial institutions more able to absorb losses. Yet the large increase of foreign-denominated private sector debt in emerging markets is a major factor of vulnerability.

At the same time, progress at the international level to cope >>>

>>> with new risks emerging from the disruption created by technological development is still modest. So far, it makes sense, in general, to monitor how the emergence of new (fintech/big tech) players and products in the market for financial services are affecting different policy objectives before taking intrusive regulatory action. Yet, in some areas like cyber-security and cryptoassets, where the case for clear policy action is already evident, the development of international guidelines or even standards is becoming increasingly warranted.

In Europe, exposure to different global risks is in some cases moderate. For instance, the degree of indebtedness of the private sector has decreased since the crisis, the relevance of leveraged finance is less than in other advanced economies and the banking union has helped strengthen the resilience of the banking sector. However, given its sizeable openness, the euro zone is heavily exposed to discontinuation of trade agreements and a possible re-emergence of protectionist measures. In addition, depending on the concrete scenario, Brexit may become a highly destabilising geopolitical development.

In addition, the euro zone is exposed to important idiosyncratic risks. In particular, both monetary and fiscal policies seem to have little room for manoeuvre in case the current signs of deceleration translate into a protracted period of low or negative growth. In that scenario, given also the increase in public debt ratios after the crisis, a re-emergence of tensions in sovereign markets could not be excluded. Low growth could further increase the vulnerability of the banking sector as it would hamper the recovery of sustainable profitability levels and the continuation of the ongoing reduction in non-performing loans.

"If risks materialise, the European crisis management framework would face difficult challenges."

\- FERNANDO RESTOY

If some of those risks were to materialise, the European crisis management framework would face difficult challenges. While the availability of a public backstop for the ESM will certainly strengthen the resolution framework, the lack of a common European deposit insurance scheme does not help break the link between sovereign and financial risk. Moreover, as recent crisis episodes have shown, the application of the bail-in tool, a key ingredient of the new resolution rules, seems in practice to be subject to important practical implementation challenges. The need to use public resources in those episodes adds further uncertainty regarding the robustness of the arrangements put in place to deal with the failure of banking institutions.

The combination of both global and idiosyncratic risks and the limitations of the crisis management framework appear especially relevant in a context in which the euro zone has not yet made sufficient progress to develop powerful public and private risk-sharing mechanisms. That implies that country-specific shocks may trigger disproportionate economic and financial instability and generate political tension in affected countries that could exacerbate anti-European political movements. Further progress in the design of mechanisms that could contribute to further economic and financial integration appears to be a priority. ●

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Vulnerabilities in the EU and challenges for macroprudential frameworks

Geopolitical factors within Europe and globally as well as the threat of protectionism continue to weigh on medium-term growth expectations. After several years of strong economic performance, the recent outlook has been weaker than expected. This is reflected in downward revisions of GDP projections and a decrease in economic sentiment indicators across most EU countries and sectors, including the financial sector. In light of these developments, the risks to EU financial stability are both structural and cyclical in nature. The non-bank sector is becoming an increasingly important part of the EU financial system, while cyclical risks are rising as reflected by weaknesses in financial institutions' balance sheets as well as debt sustainability challenges in the public and private sectors.

Low funding costs and the search for yield environment can lead to the mispricing of risks and encourage excessive risk taking. Policy uncertainties in some EU countries, the United Kingdom's withdrawal from the European Union, and the possible materialisation of risks in some key emerging market economies contribute to the uncertain economic outlook. The crystallisation of existing risks could trigger a shift in investor sentiments and induce a rapid repricing in financial markets. This vulnerability is reflected in recent price declines and rising implied volatility across market segments in some advanced and emerging market economies. Some asset classes with compressed risk premia in recent years are particularly at risk of price adjustments. This includes corporate bonds, leveraged loans, real estate markets in some countries and certain stock markets. The commercial real estate sector, for example, has been experiencing an expansionary phase in recent years and the European Systemic Risk Board (ESRB) has previously highlighted the risk from historically high prices.

The non-bank sector has gained importance for the financing of the real economy and assets held in investment funds and other financial institutions increased over the past decade from around EUR 23 trillion in 2007 to just over EUR 43 trillion in 2017. Some of the risks that were previously present in the banking sector have migrated to non-banks, resulting in an increasing >>>

>>> focus on assessing and tackling risks and vulnerabilities in this sector. From a cyclical perspective, a common pattern observed during the past few years in the current low-yield environment is that some EU bond funds have shifted their asset allocation towards lower-rated debt securities. As a result, there are some concerns that if yields in bond markets were to rise suddenly, bond funds could face large falls in value and subsequent outflows.

To help address these risks, macroprudential frameworks have been significantly strengthened across the EU in recent years. Most EU countries have created macroprudential authorities, macroprudential tools have been developed and frameworks for international cooperation have been strengthened such as the reciprocity framework within the EU. In recent years, authorities have also made use of macroprudential instruments such as the countercyclical capital buffer. However, the macroprudential framework must continue to evolve to adjust to ongoing structural changes such as the growth of the non-banking sector. Overall, the deepening financial integration relies on cooperation, information sharing and reciprocity, and it is important to ensure that macroprudential frameworks allow for monitoring and addressing the vulnerabilities in the cross-border and cross-sectoral context. ●

"The crystallisation of existing risks could trigger a shift in investor sentiments."

\- FRANCESCO MAZZAFERRO

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There is no room for complacency in a world of increased uncertainties and risks

Since last summer, there has been a series of negative surprises in the global environment: a resurgence of trade tensions between the United States and its partners, notably China; tensions surrounding the Italian budget; the British parliament's rejection of the Brexit deal; and in France the scale and duration of the so called gilets jaunes movement. As a result, the macroeconomic outlook is now less favorable than anticipated a few months ago and exacerbates the risks faced by financial institutions.

First, it raises greater concerns over the sustainability of the high debt levels carried by economic agents, especially in the event of an upward shock to interest rates or a downward shock to activity. The growing uncertainty also feeds the risk of abrupt and marked downward corrections in financial asset prices as they seem elevated from a medium-term perspective. In addition, the low interest rates environment could be prolonged and, despite its overall consistency with the macroeconomic context, have further implications for the economic agents' borrowing behavior and for the profitability of financial intermediaries.

In addition to these cyclical risks, a number of new and structural risks are emerging, including those arising from the digitalisation of the financial industry. Digitalisation requires huge investment, the management of complex projects and greater agility on the part of financial institutions. Therefore, it carries a significant execution risk. Digitalisation is also challenging existing business models and their viability and may have potentially destabilising effects for the banking sector, especially in Europe where there are overcapacity issues and where profitability is rising but remains well below US levels. Finally, digitalization gives operational risk a more systemic footprint.

Yet banks are able to address those risks. They have more and better quality capital as well as larger liquidity buffers than ten years ago, before the Great Financial Crisis. Besides, risk and compliance functions have now become an essential part of their organisations. In Europe in particular, the banking sector has been made more resilient also through major institutional reforms, including the creation of the Single Supervisory Mechanism under the aegis of the ECB and of the Single Resolution Mechanism. More broadly, the financial system operates in a sounder regulatory framework thanks to the reforms steered by the G20.

However, this outcome should not be a reason for complacency. Supervisors as well as financial intermediaries need to exercise their vigilance in order to understand the risks they face, and take appropriate steps to manage them. This is true for both microprudential and macroprudential supervisors.

Macroprudential policy plays a complementary role alongside microprudential supervision, by following a more preventive approach that addresses the financial system as a whole. In that spirit, the French macroprudential authority, the Haut Conseil de stabilité financière, has taken steps to prevent negative consequences of the growing indebtedness of the private non-financial sector: cap on bank exposures to large and highly indebted corporations at 5% of their capital; banks' countercylical capital buffer raised to 0.25%.

Macroprudential policy should also be concerned with emerging structural risks, strengthen their analytical capabilities, in order to better understand the consequences of morphing interconnections, eventually conducting stress tests across the entire system rather than just in individual sectors, and adapt their macroprudential policy to the new challenges.

In 2019, more than ever, vigilant microprudential supervision and macroprudential policy should be our compass to advance in a world of uncertainties. ●

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Stay focused on building resilience while being mindful of the risks of regulatory fragmentation

The global financial crisis exposed a number of vulnerabilities in the financial system. Many of these were not anticipated due to a lack of cross-border coordination. The necessity for cross border coordination is reflected in the work that has been done over the past ten years by global standard setters, central banks and regulatory agencies, in dialogue with the industry. It has been widely agreed that the vulnerabilities that existed pre-crisis have been addressed; banks have stronger capital and liquidity buffers, the derivatives market is reformed and steps have been taken to address the risks of 'too-big-to-to fail' institutions.

As the post-crisis reforms continue to be implemented and reviewed at a national level, it is important to remember the objectives set by the global regulatory community when the rules were designed; making the financial system more resilient while preventing market fragmentation. While the point on resilience has been addressed in many areas, there are signs of regulatory fragmentation due to divergence of implementing standards on key areas of the global reform agenda.

It must be said that implementing international standards requires a certain level of flexibility to reflect specificities from a risk perspective in a local or regional context. It has, however, become apparent that certain local supervisory measures might become an issue for banking institutions that operate globally. Regulatory fragmentation does not only lead to a reduction of regulatory and supervisory effectiveness but may also negatively impact cross-border investment and economic activity by preventing financial institutions from optimising the allocation of financial flows.

"It is important to address regulatory fragmentation early on in the implementation process."

\- TOMOHIRO ISHIKAWA

It is important to address regulatory fragmentation in the early stages of the implementation process, as firms have to adapt to a changing regulatory landscape and once the adjustment is done, it is operationally challenging to undo some of the strategic decisions that have been made to comply with the rules. We welcome Japan's leading role in the debate on fragmentation by putting it on this year's G20 agenda. It is also encouraging to see that the FSB has recognised the need to address the risk of regulatory fragmentation and its potential impact. However, further action may be needed to address specific conflicting regulatory and supervisory actions.

The overall aim going forward - which is in the interest of both private and public stakeholders - should be to preserve long-term financial stability, fostering innovation and economic growth and avoid relying on the increasing build-up of leverage. Cross border regulatory coordination and engagement, also about potential conflicts, can help building trust about the fact that financial institutions are indeed resilient. While it is not easy to strike a perfect balance between macro and micro prudential measures, we should not give up on striving for this balance in a globally coherent manner. The regulatory and supervisory approach designed today will be the safeguard of tomorrow's financial system, both in the EU and beyond. Continuing on a path of cooperation and coordination will prepare the financial system in all corners of the world for new risks looming on the horizon, such as cyber risk, climate risk and the ongoing digitalisation of the financial sector. ●

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Among all risks facing the financial sector, profitability is the most critical

Plenty of risks surround the European financial sector:

- While Europe has largely been spared higher tariffs so far, the U.S. administration's focus on cars imports could mark a turning point;
- Market volatility amid the normalization of monetary policy could turn a mature credit cycle;
- China's attempts to control its own indebtedness have been hurting European exports;
- Lasting political uncertainties are dampening business investment in Europe; and
- Cybersecurity and disruptive technologies are externalities that the financial sector needs to internalize.

While most of these external risks are manageable or can dissipate at some point in time, this is not the case for low interest rates. So, it is certainly no understatement to say that low interest rates remain the key issue for the European financial sector.

Ten years after the Great Recession, one can argue that the European financial sector is more resilient than before, bank's balance sheets are in best shape they've been in decades. Banks have enhanced their capital bases, liquidity buffers have been built, stress tests are run regularly to identify possible pockets of losses in bank portfolios. >>>

>>> Cheap central bank liquidity is plentiful and a palliative to an increase in external funding costs. Nevertheless, the profitability of many European banks is once again at historical lows. While European companies in the Euro Stoxx 50 Index are priced at 1.5x their book value, many Europeans banks are priced at less than 0.6x. Such low valuations correspond to previous episodes of severe economic downturns in 2008, 2012, and 2015.

"Low interest rates remain the key issue for the European financial sector."

\- SYLVAIN BROYER

Low interest rates and a flat yield curve are among the root causes of this low profitability. They simply make the transformation of short-term savings and deposits into long-term lending less lucrative for banks. The banking sector is not the only victim. Low interest rates in the current regulatory framework compel insurance companies, as well as nonfinancial corporations with pension liabilities, to set aside considerable amounts of funds to secure future payments. The consequences are higher retained earnings and therefore less investment. The situation for banks is particularly worrying because low profitability could overtime undermine bank's lending capacity and reduce loan supply to the economy.

A rapid increase in interest rates is certainly not desirable. But can they gradually return to the levels seen before the Great Recession? There is room for doubt. Low productivity and demographic change are making their singular mark on this economic expansion, both of which point to slow growth and subdued inflation. Central banks will find it difficult to exit their accommodative monetary policies, independently of whether they change their mandate or not. Moreover, the demand for safe assets like U.S. Treasuries or German Bunds seems to exceed supply, despite the widening in the U.S. budget deficit on one side and the shrinkage of the Fed's balance sheet on the other.

Banking will therefore remain a low-margin business for a long time to come, which may bring consolidation and restructuring. As the European economy is still mostly financed by banks, a retrenching banking sector could have implications for employment and prosperity on the Continent. ●