KEY MACRO AND MICRO RISKS THAT MAY AFFECT EU FINANCIAL MARKETS

Ten years have passed since the onset of the worst financial crisis since the Great Depression. Since then, historically low, even negative, interest rates and unprecedentedly large central bank balance sheets have provided important support for the global economy. Persistently low interest rates facilitated notably a deleveraging in those countries and sectors that were at the epicenter of the crisis – in particular, households and banking sectors in major advanced economies.

The last financial crisis was activated by rapid leveraging, particularly in the US but current global leveraging is moving faster than during the pre-crisis period. Financial conditions are indeed easier than before the Great Financial Crisis (GFC) when many investors, households, corporations and sovereigns were caught out in the rain with no umbrella. But, lasting very low interest rates have triggered a continuous rise in the global stock of debt, private and public. The world is now 12 per cent of GDP deeper than the previous peak in 2019. Experience shows that in a cyclical upswing, it is wise to raise interest rates in order to create margins to reduce them when the next recession comes.

The most damaging consequence of the crisis has probably been the postponement of the implementation of pro-growth structural reforms. Accommodative financial conditions cannot boost long-run growth potential. Implementing growth-friendly structural reforms will become harder as monetary accommodation is withdrawn. And there is no denying that the room for manoeuvre in terms of monetary and fiscal policies is narrower today than 10 years ago. In addition, the continued growth of nonbank finance requires further efforts to properly monitor risks and react appropriately through regulation and supervision.

1. Considerable progress has been achieved over the last decade in strengthening the resilience of the financial system

The post crisis financial reforms[1], not least Basel III and the implementation of macro prudential frameworks have bolstered the financial system. Banks are now better capitalised, more resilient and better able to cope with financial instability. Other reforms, such as minimum requirements for global systemically important banks' (G-SIBs) total loss-absorbing capacity, enhanced bank resolution regimes and the central clearing of all standardised derivatives contracts, are being implemented in parallel.

2. Given how much levels of debt have risen over the decade, risks ahead are material

Persistent low funding costs and the search for yield environment can lead to the mispricing of risks and encourage excessive risk taking.

Lasting very low interest rates have triggered a continuous rise in the global stock of debt, private and public, in relation to GDP. Global debt is at historic highs. Total nonfinancial sector debt—borrowings by governments, nonfinancial companies, and households—has expanded at a much faster pace than the growth rate of the economy. As a result, total nonfinancial debt in countries with systemically important financial sectors stands in 2017 at $167 trillion, or over 250 percent of aggregate GDP[2], compared with $113 trillion (210 percent of GDP) in 2008. The world is now 12 percent of GDP deeper in debt than at the previous peak in 2009.

Non-financial companies have dramatically increased their borrowing in the form of corporate bonds[3]. According to a recent paper issued by OECD[4], between 2008-2018, global corporate bond issuance averaged USD 1.7 trillion per year, compared to an annual average of USD 864 billion during the years leading up to the crisis. The risks and vulnerabilities in the corporate debt market are also significantly different from those of the previous pre-crisis cycle. The share of lowest quality investment grade bonds stands at 54%, a historical high. At the same time, in the case of a financial shock similar to 2008, USD 500 billions' worth of corporate bonds would migrate to the non-investment grade market within a year, forcing sales that are hard to absorb by non-investment grade investors.

The continuous accumulation of debt is worrying for at least two reasons. First, the higher the debt, the more sensitive the economy and financial valuations are to higher interest rates. This, in turn, makes it more difficult to raise them, favouring further debt accumulation – a kind of "debt trap". Second, higher debt – private and public – narrows the room for policy manoeuvre to address any downturn. Experience shows that in a cyclical upward episode, it is wise to raise interest rates in order to create margins in order to reduce them when the next recession comes.

High sovereign, corporate and household debt levels in many parts of the world could expose the financial system

[1] In 2009, the G20 launched a comprehensive programme of reforms, coordinated through the FSB, to increase the resilience of the global financial system. These reforms were built on the four pillars of: making financial institutions more resilient; ending the problem of financial institutions being too-big-to-fail; making over-the-counter (OTC) derivative markets safer; and transforming shadow banking into resilient market-based finance.

[2] Figures quoted in the Global Financial stability Report, IMF, Oct 2018.

[3] The sustainability of public debt in the EU is analysed in a separate note since a specific session is dedicated to this topic.

[4] OECD, "Corporate markets in a time of unconventional monetary policy", February 2019.

to market losses, rising credit defaults and increased rollover risk as monetary conditions tighten. Indeed, over extended corporations can experience difficulties to service their debt when growth slow down.

Looking ahead, a sharp tightening of global financial conditions could be trigged by a further escalation of trade tensions or by a sudden shift in risk sentiment caused by rising geopolitical risks or policy uncertainty in major economies (For example, uncertainty about fiscal policy in some highly indebted euro area countries could damage confidence in financial markets).

3. The toolkit needs to keep pace with new developments in the non-bank financing area

Non-bank institutional asset managers, ranging from investment management companies to pension funds and insurers have grown strongly over the past decade. Their total assets are estimated at nearly $ 160 trillion according to the BIS, exceeding those of banks worldwide.

M. Draghi stated[5] that "non-bank finance is playing an increasingly important role in financing the economy. The shadow banking sector[6] accounts for around 40 per cent of the EU financial system, with total assets of just over €42 trillion. As the Capital Markets Union (CMU) progresses, the role of non-bank finance is expected to increase further.

Certain asset management products and activities may create potential financial stability risks particularly in the area of liquidity and redemption, leverage, operational functions, securities lending, and resolvability and transition planning. Many of these risks are now mitigated by funds legislation notably in the EU.

Strong demand for high yield debt has been accompanied by lower covenant protection for lenders/investors

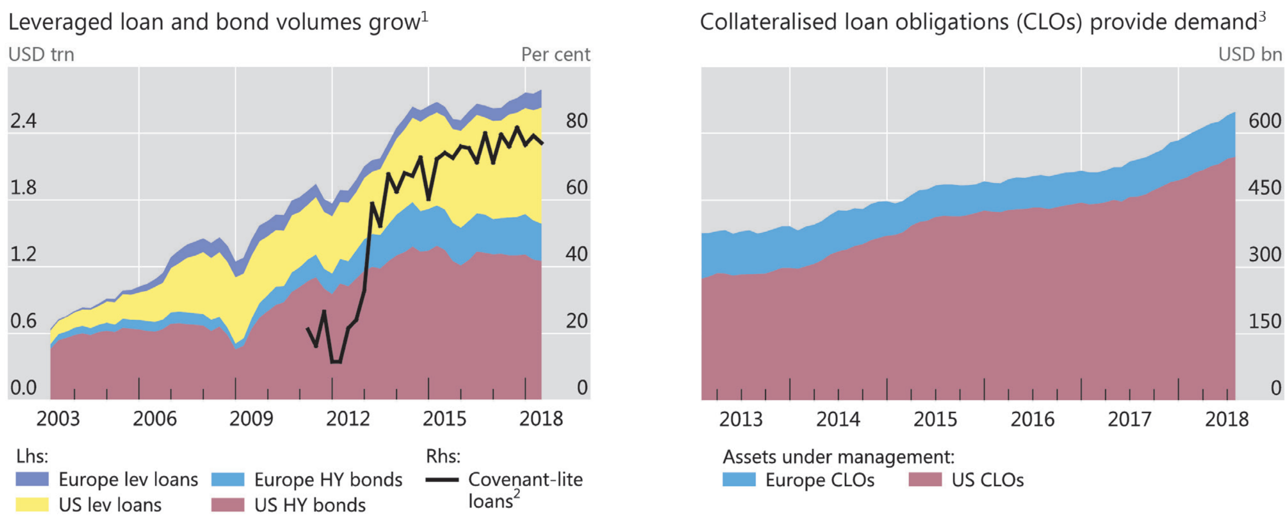
Over the past decade, we have seen, in the current intense search for yield, both nationally and internationally, often reflecting excessive risk-taking by investors. This has dramatically compressed risk premia, including term premia and credit risk premia in corporate and EME sovereign yields.

In a recent speech[7], A. Carstens explained that In the United States and Europe, the volume of high-yield bonds and leveraged lending has picked up in recent years, and leveraged loans tend to have fewer covenants. One driver of this surge is the revival of collateralised loan obligations, which have grown steadily in volume.

According to the Financial Stability Board[8], roughly $1,4 trillion in institutional leveraged loans, or loans purchased by institutional investors other than syndicate banks, was estimated to be outstanding globally as of October 2018. This outstanding amount of leveraged loans is even higher if the amount that syndicate banks retain on their balance sheets (which includes revolving credit facilities, letters of credit and certain term loans) is taken into account[9]. Available data suggest non-banks purchase the vast majority of leveraged loans in the primary market and therefore have greater exposure to potentially adverse market developments.

Risk-taking picks up

Chart 1



[1] For institutional leveraged loans (lev loans), outstanding amounts are based on S&P/LSTA leveraged loan index (LLI) for the US, and S&P European leveraged loan index for Europe, where LSTA = Loan Syndications and Trading Association; for high-yield (HY) bonds, outstanding amounts are based on the USD high-yield ICE BofAML index for the US and the EUR high-yield ICE BofAML index for Europe. [2] Based on US market deals. [3] "US CLOs" covers USD-denominated issuances and "Europe CLOs" EUR-denominated issuances.

Source: A. Carstens, "Shelter from the storm", Seminar at the European Stability Mechanism, Luxembourg, 7 December 2018.

---

[5] M. Draghi, "Welcome remarks at the third annual conference of the ESRB", Frankfurt, 27 September 2018.

[6] The EU shadow banking measure includes all assets of the financial sector except those of banks, insurance corporations, pension funds, and central counterparties (CCPs). Within the EU shadow banking system, investment funds account for about one third and so-called other financial institutions (OFIs), including securitisation vehicles, account for the remainder.

[7] A. Carstens, "Shelter from the storm", Seminar at the European Stability Mechanism, Luxembourg, 7 December 2018.

[8] Financial Stability Board, "Global Monitoring Report on Non-Bank financial Intermediation, 4 February 2019.

[9] The total market size of leveraged loans is difficult to estimate given that: (i) leveraged loans are private, and therefore transaction data in some cases are not publicly available (in particular for the middle market and direct lending segments, where leveraged loans typically are bilateral or not broadly syndicated); and (ii) commercially available data sources vary in methodology and coverage.

4. Improving macroprudential tools for reducing systemic risk where financial vulnerabilities are building up

Macroprudential frameworks have become a key new element of the post-crisis financial reforms designed to ensure financial stability. 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. This is important because the Great Financial Crisis (GFC) and previous crises have shown that vulnerabilities may build up across the system even though individual institutions may look stable on a standalone basis.

Macroprudential instruments in the EU are for the most part aimed at the banking sector, given the predominance of bank-based finance at the time that the initial response to the global financial crisis was designed.

But as explained by Claudio Borio[10], more must to be done: to better identify risks and calibrate the tools; to develop tools that target the non-bank sector; and to implement mechanisms to address cross-country leakages. To deal effectively with systemic risks stemming from asset management funds and other institutional investors, close cooperation among the various authorities involved is crucial: central banks, bank regulators, insurance regulators and securities regulators.

According to M. Draghi, the policymakers' ability to mitigate the risks related to the development of non-bank financing, is hampered by an incomplete toolkit. Policymakers need a comprehensive macroprudential toolkit to act in case existing risks migrate outside the banking sector or new risks emerge. And that means widening the toolkit so that policymakers can effectively confront risks emerging beyond the banking sector. Additional tools should deal with liquidity risk and those risks associated with leverage among some types of investment funds. Fund managers themselves also need to be given a broader range of tools to better manage such risks. The wider toolkit includes, according to M. Draghi, macroprudential tools for insurance.

5. Monetary policy normalization is essential

Monetary policy normalization is important in rebuilding policy space. It can create room for countercyclical policy, help reduce the risk of the emergence of financial vulnerabilities and contribute to restraining debt accumulation.

5.1 Normalization raises a big issue in the Eurozone: the one of public debt and finance

Public debt remains very high at around 90% of GDP in the euro area. Some core countries of the euro area are still running substantial primary fiscal deficits. Therefore, if and when monetary policy becomes less accommodative and interest rates rise, the cost of a public financing of the Eurozone will feel strong pressure as well as a significant impact on budgetary outlays.

The time provided to European Governments by the massive fall in interest rates (that has reduced to a minimum the debt service burden of these States), has not been sufficiently used to start meaningful structural reforms that are needed to achieve the reduction of excessively high public expenditures and to revitalize the supply side. In essence, the ECB's understandable interventions in the government bond markets have pari passu weakened market pressure and discipline on governments.

5.2 Too much responsibility may have been put on the shoulders of Central Bankers over the years

One reason for the current vulnerabilities is that central banks have had to bear the burden of the post-crisis recovery. In the old days, Central Banks used to fight against inflation by raising short term interest rates and monitoring credit expansion. Today they have become quasi responsible for the whole outcome of economic cycles.

Their core mission is to ensure maximum growth over the cycle by forcing long term rates to fall and remain low. This has enticed the ECB into hyperactive monetary policies. Such policies – whatever their short-term advantages – can bear long term costs that could be very significant, notably concerning the stability of financial markets as well as on the profitability of the banking sector. The longer the period of exceptionally low rates, the stronger the impact on interest rate margins.

The time has come to overhaul such policies and to correct the mistaken view that money creation can, by itself, resolve structural economic problems which can only be addressed by structural reforms. Public debt will fall much faster if growth – boosted by such reforms – is higher than the present forecasts. ■

[10] See C. Borio, Macroprudential frameworks: experience, prospects and a way forward, BIS, 24 June 2018.