Vítor Constâncio: Reinforcing financial stability in the euro area

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the Official Monetary and Financial Institutions Forum (OMFIF) City Lecture, London, 8 May 2015.

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Ladies and Gentlemen,

Thank you for inviting me to speak about the elements needed to reinforce financial stability in the euro area. In what follows, I will start by recalling the benefits of current monetary policy for financial stability. I will then turn to those risks for financial stability that should be addressed by supervision and macroprudential policy. While recent regulatory efforts have made the banking sector more resilient, I see a need to expand the set of macroprudential instruments that focus on the non-bank financial sector. In my intervention today, I will therefore outline the associated elements which, in my view, are still incomplete for safeguarding financial stability.

The interplay of monetary policy and macroprudential policy

Low nominal growth has been the underlying factor of the main risks for financial stability in the euro area. The financial crisis, the slow recovery and the low inflation rate, particularly in the euro area, have created an environment of low interest rates in financial markets, which has been further accentuated by a necessarily accommodative monetary policy. The policy pursued by central banks has been essential to stabilise our economies and to dispel the risk of possible deflationary episodes or of a prolonged "low-flation" regime. In particular, a possible further reduction in inflation expectations would have had a direct effect on real interest rates leading to an unwarranted tightening of financial conditions with an unfavourable impact on inflation and economic growth.

It has to be recognised that a prolonged period of low interest rates contributes to "search for yield" and possible rich asset valuations which may generate financial stability concerns. This environment however, is the result of weak economic conditions and low inflation, the related market players' decisions, and the central bank's response to these conditions. Low medium and long-term interest rates are not just caused by monetary policy. As the last few days have shown, market players' decisions may overwhelm central bank policies. Furthermore, in the last decades, there has been a global trend for lower real interest rates which is related to secular stagnation resulting from a continuous deceleration of total productivity growth and an increase in planned savings. Monetary policy short-term rates are low because of these developments, not the other way around. At the same time, monetary policy needs to remain accommodative in order to normalise inflation levels close to our objective, thus leading to higher interest rates.

Consequently, the ECB monetary policy measures that have been taken since summer last year, including most recently the expanded asset purchase programme (EAPP), not only contribute to maintaining price stability but are also beneficial for financial stability. Specifically, I expect the current monetary policy stance to strengthen aggregate demand in the euro area on the back of lower real interest rates and improved confidence. Higher actual and expected inflation closer to our price stability objective also help alleviate the real debt burdens of households, firms and governments, which otherwise could have been subject to adverse debt dynamics. Credit worthiness of firms and households should improve on account of higher net worth induced by asset price increases. Moreover, as bank funding cost should continue to decline, I expect to see a further easing of credit standards on loans to enterprises as was already noticeable in the latest ECB Bank Lending Survey.

Our policy is indeed working according to plan. Conditions in a host of asset markets, from equities to bonds or foreign exchange, have reacted in the expected way through the

portfolio rebalancing transmission channel of monetary policy. In the euro area, equity prices have gone up by 13% since January. Corporate bond yields came down by 49 basis points since June last year and the most recent (March) data on bank lending rates shows that rates decreased by 70 basis points, with respect to last year. This last point shows that our policies are also improving the credit channel, which is confirmed by the fact that credit (bank loans) to the private sector reached a turning point, as shown by net positive monthly flows in the last three months. More expansionary financial conditions are supporting the recovery as well as the increase of inflation expectations. In fact, the 5y/5y ahead swap rate went up from 1.6% in January to 1.8% at present.

No policy intervention is without side effects. Indeed, as I mentioned already, a very accommodative monetary policy stance geared towards maintaining price stability in the presence of already generously priced asset markets may also lead to potential risks for the stability of the financial system. Nevertheless, monetary policy must be focused on inflation and/or growth according to the different central bank mandates and therefore, such risks need to be addressed by policy instruments dedicated to ensuring resilience while curbing cyclical excesses – that is, supervision and macroprudential policy.

In the current situation, we see that risks stemming from excessive risk-taking or any misaligned asset prices are contained in the euro area. This assessment is supported by continued moderate private sector credit expansion and leverage. However, we have certainly noticed that equity prices have continued to rise – albeit from previously low levels – and that sovereign bond yields are historically low. Moreover, ECB estimates suggest that corporate bond risk premia are moving towards levels seen before the financial crisis. In addition, co-movements in financial markets have increased since summer 2014.

These developments justify the need for close monitoring with a particular focus on asset markets but also on banks, insurers and pension funds as well as the less-regulated non-bank financial sector and the non-financial private sector.

As financial and business cycles are not always aligned across countries and sectors in the euro area, area-wide monetary policy needs to be complemented by more targeted macroprudential policy. Unlike monetary policy that influences the euro area across the board, macroprudential policy instruments can be applied in a granular manner, addressing risks at the country, sector and institutional level. Macroprudential policy therefore provides the most appropriate instruments for mitigating financial stability risks, thereby supporting the price-stability oriented monetary policy.

In that respect, concerns about the stability of the banking system have been addressed over recent years, through efforts to put a comprehensive regulatory framework in place and notably the set-up of banking supervision at the European level with the establishment of the Single Supervisory Mechanism (SSM). The regulatory framework for banks is at this stage largely in place. But a few important elements such as leverage ratio, the Net Stable Funding Ratio (NSFR) and Total Loss Absorbing Capacity (TLAC), which should be finalised in order to complete our framework for banks, are outstanding. In addition, macroprudential tools for the banking sector are also available but should be extended to also encompass LTV (Loan-to-Value) and DTI ratios (Debt-to-Income), the leverage ratio, limits to specific large exposures to shadow banks and to maturity transformation.

Given the achievements in the regulatory framework for banks and the changing landscape in the euro area financial system, our attention naturally shifts to the more opaque and less regulated parts of the financial system. Let me next turn to what is needed beyond the banking system.

The need for macroprudential tools beyond banks

So far, the regulatory reform has largely focused on the banking sector with the effect of activities and assets in other sectors growing faster than in the banking sector. Growth of the

non-bank financial sector in the euro area has gathered pace in recent years, following the global financial crisis, accompanied by a shift to market-based funding. The expansion of the non-money market investment funds sector has been the main source of growth of the shadow banking sector.

Using the Financial Stability Board's (FSB) broad definition of shadow banking, assets of non-bank financial entities in the euro area have more than doubled over the past decade, to reach EUR 23.5 trillion by December 2014. Since 2009, non-bank entities have increased their share in total assets of the financial sector from 33% to 37%, while, in parallel, credit institutions have seen their share of intermediation shrink from 55% to 49% of the approximately EUR 60 trillion of total assets in the euro area financial system.

This strong growth and increasing role of non-bank entities in the euro area financial system, warrants closer scrutiny of their structural and cyclical developments, including risks to financial stability.

Non-bank entities are increasingly important providers of credit to the real economy. On the positive side, they represent a second source of funding for the real economy in addition to banks, and help diversify the funding base of financial and non-financial corporates. This will be particularly important in times of deleveraging in the banking sector. However, the growing role of non-bank entities in the euro area implies that the systemic relevance of these entities is also on the rise. Non-banks can also exert costs on the wider financial system and can, just as easily as banks, become excessively risky and too-big-to-fail. What this requires is enhanced monitoring, a broader regulatory perimeter, strengthened supervision and the development of a more comprehensive macroprudential toolkit.

At the current juncture, two factors in particular warrant attention. First, there is a growing concern over the potentially destabilising role of non-bank entities in sharp price adjustments in asset markets. Solvency concerns are muted due to a high share of equity, for instance in the investment funds sector, while key vulnerabilities result from liquidity transformation and the procyclical provision of liquidity to financial markets. Second, the use of leverage embedded in derivatives positions as well as securities lending and financing transactions has become widespread, potentially adding to liquidity spirals in a stress scenario. Any large-scale portfolio rebalancing among investment funds could therefore result in significant swings in asset prices and market liquidity, possibly increasing funding costs for key euro area sectors.

The investment fund sector provides a case in point: while the ECB believes that the sector is overall adequately regulated in the EU from an investor protection point of view, i.e., by the UCITS and Alternative Investment Fund Managers Directives, concerns have risen over the past few years that this sector in particular, could be part of future systemic events. These are now worldwide concerns expressed by the IMF or the FSB.

One of the main vulnerabilities stemming from the investment fund sector relates to the so-called liquidity spirals. These may be triggered if funds are confronted with strong redemptions or increased margin requirements, as these could result in forced selling into markets with low liquidity. With these liquidity conditions, initial asset price adjustments would be amplified, triggering further redemptions and margin calls, thereby fuelling such negative liquidity spirals. The market impact of large-scale outflows could be aggravated by strategic complementarities among fund investors, in particular, resulting from first mover advantages and asset managers being forced to adjust portfolios in a timely manner. Market impact of investment funds is potentially strong, in particular for the euro area secondary bond markets, as investment funds hold a substantial and growing proportion of the debt securities of euro area banks, governments and non-financial corporates.

Liquidity and maturity transformation outside the regulated perimeter have been further spreading risks across institutions and countries during the global crisis. While regulatory reforms have addressed the most apparent problems, new players and business models which require close monitoring are likely to emerge.

The growing size and the associated risks arising from non-bank entities and activities call for efforts to strengthen the supervisory framework for this sector. Entities and activities outside the regulatory perimeter will require enhanced oversight and supervision. The following three points are particularly relevant to achieve this.

First, we need more information, and we need to develop a monitoring framework for the rest of the financial system. Second, we need to create and develop macroprudential tools for both entities and activities in the non-bank sector. And finally, we need to strengthen our regulatory and institutional base in Europe to ensure the efficient application of macroprudential measures.

Let me expand on each of these three points.

A monitoring framework beyond banking

A prerequisite for an efficient application of macroprudential tools beyond banking is the need to have sufficient knowledge and information about the entities and activities in this space.

While very few sectors in the euro area involved in financial intermediation remain truly unregulated, monitoring of non-bank entities at the euro area level remains largely fragmented due to data limitations. The recent collection by the ECB of balance sheet items of investment funds and the Financial Vehicle Corporation (FVCs) classification exercise has provided detailed data and enabled a better surveillance of the euro area non-bank financial sector. However, granular statistics are still not available for more than 50% of the sector's assets. Following the recent ESA 2010 reclassification, some limited information is available on size, asset composition, and geographic distribution of this "residual".

Limited balance sheet statistics would provide some weight to the assumption that most of the residual entities are Special Financing Institutions (SFIs) or holding companies which would not be included in the FSB concept of shadow banking.

Coverage of the investment funds sector is much more comprehensive, where the ECB has collected statistics on the types of funds, and their asset and liability decomposition. Still, the ability of the authorities to monitor and map specific risks in the euro area remains limited. Gaps remain with respect to synthetic leverage created by derivatives as well as securities lending and financing transactions in the shadow banking sector. Targeted data collection projects have been initiated to fill these gaps, including derivatives reporting under EMIR and further reporting requirements of securities transactions under MiFID.

Another angle to address risks in the non-bank sector is to shed further light on and monitor certain activities that give rise to stability concerns, notably in the derivatives, repo and securities financing markets. Risks in these markets may also be created by entities domiciled in jurisdictions outside the euro area, which may otherwise escape the monitoring perimeter.

Macroprudential tools for non-bank entities

The importance of market-based finance and in particular of asset managers and the new vulnerabilities they may create, lead me to strongly share the view recently voiced by a number of prominent supervisors that we need to push ahead to develop a toolkit of policy measures. Most importantly, the FSB has started looking into the financial stability risks associated with asset management activities, as well as longer-term structural financial stability issues that may arise.

This is not to say that the asset management sector is unregulated. In fact, we have a very successful investment fund regulation in Europe. However, this regulation is largely tailored to protect investors rather than to contain risks for financial stability. We need to turn some of

the instruments already available to managers of investment funds into macroprudential tools.

Specifically, additional liquidity requirements, guided stress tests, minimum and time-varying load, and redemption fees should be part of the macroprudential toolbox. Well defined limits to leverage, especially synthetic leverage built-up with derivatives, should also be introduced.

In general, it is necessary to intensify the oversight of systemically important non-bank institutions as is the case in the U.S.A. We need to curtail risks from these systemic players and raise their resilience through the financial cycle. A first step in this direction is the work done by the FSB that develops a common methodology to identify systemically significant non-bank and non-insurers. The FSB is currently also working on the systemic risks in the asset management industry.

Other measures concern activities or instruments used in the market-based financial sector. In particular, I have in mind minimum and countercyclical haircuts for Securities Financing Transactions (SFT). Countercyclical haircuts would limit volatility and leverage in financial markets more effectively than the minimum haircut requirements recently recommended by the FSB. Another important FSB workstream focuses on re-hypothecation and re-use of securities in the repo market. These create chains of inside liquidity that enhance the "illusion of liquidity", which tend to disappear in times of stress.

Further work to understand the effects of these tools and how best to apply them in practice is encouraged.

A new regulatory and institutional base in Europe

I have listed a number of tools that would help safeguard financial stability in the euro area. However, the legal and institutional base would need to be changed in order to implement the policies required to address the risks from non-banks. This is particularly true in the context of the implementation of the Capital Markets Union, because it implies the creation of a single rulebook for capital markets oversight and the clear definition of the mechanisms at the European level. These would need to be adjusted in order to ensure the harmonised application of such a rulebook in the whole single market. I presume that an enhanced role for ESMA will have to be considered.

In this context, it is paramount that authorities, through the development of a macroprudential framework, have the tools to deal with the build-up of systemic risks at their disposal. We also need to establish the legal base to place systemically important non-banks within the perimeter of enhanced supervision in Europe. In the United States, non-bank Systemically Important Financial Institutions (SIFIs) (designated by the U.S. Financial Stability Oversight Council) are placed under enhanced prudential supervision by the Federal Reserve Board of Governors. This step has already been implemented for some institutions while non-bank SIFI designation is being studied for some large asset managers. I believe it is important that competent authorities in Europe are equipped with similar powers.

Conclusion

Let me conclude.

Our current monetary policy setting is beneficial not only for euro area price stability but also for financial stability. At the same time, we are aware that a build-up of risks in the financial system can arise in a situation of protracted low interest rates and abundant liquidity. Such risks should be addressed by macroprudential policy in a targeted manner at country and sector level.

It is essential to ensure that our financial system is well capitalised, liquid and resilient, in dealing with the challenges to financial stability and avoiding future financial crises. This holds particularly for Europe with its heterogeneous financial system. We are currently

experiencing a significant shift away from bank-intermediated finance and this process will continue in the future. A broadened toolkit is therefore required. We need the ability to take decisive and intrusive macroprudential policy decisions and a framework that is sufficiently broad to capture all relevant systemic institutions and activities. This becomes even more critical when monetary policy needs to be accommodative, as I expect will be the case for the foreseeable future in the euro area.

Thank you for your attention.