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Building resilience in markets - Remarks by Deputy Governor Vasileios Madouros

16 May 2023 **Speech**

Remarked delivered at the Managed Funds Association Global Summit

Thank you for the invitation to take part in today's conference.[1]

As you know, central banks and regulators globally have been increasingly focused on the resilience of markets and, within that, the role of non-bank financial intermediation.

At the Central Bank of Ireland, we are in a relatively unique position to consider these issues given the breadth of our mandate: we are the central bank, the financial stability authority and the securities regulator.

This means that, when we think about markets, we take a holistic view on why they matter from a public policy perspective.

In that context, in my remarks today, I will focus on some of the structural changes in the financial system in recent years; what these mean for market functioning, especially in times of stress; and how strengthening resilience of non-bank finance can contribute to better functioning markets.

Ultimately, more resilient markets entail benefits both for investors and the broader economy.

The benefits of market-based financing

Economists have been considering the relative merits of bank-based versus market-based financial systems for decades.[2]

I will spare you an attempt to weigh into that debate in the time available.

But one thing seems clear: in a financial system that remains tilted towards bank financing, like the one we still have in Europe, deepening capital markets can bring benefits for the economy and society as a whole.

Market-based finance provides a valuable alternative to bank financing, supporting economic activity.

It allows investors to channel their savings to a broader range of assets, enabling portfolio diversification.

And it can facilitate risk sharing across the financial system, with potential benefits for macroeconomic stability.

The benefits of deeper and more accessible capital markets are reflected in the EU's policy agenda on Capital Markets Union (CMU).

While there is still much further to go to achieve a full CMU, it is clear that market-based financing has become increasingly important in the EU as the financial system has continued to evolve.

For example, the share of total financial sector assets held by banks in the Euro Area has fallen by around a third since the period before the financial crisis.[3]

The share of new borrowing by companies in the EU through market-based financing has almost doubled over the same period.[4]

And the share of commercial real estate assets held by investment funds has also doubled across the Euro Area over the past decade.[5]

So market-based finance has been growing in Europe, a trend that is also mirrored internationally, with potential benefits for the economy as a whole.

The need for resilience in markets

For those benefits to be realised fully, however, a critical precondition is that markets are resilient in the face of adverse shocks.

If market financing is there in good times only, and disappears or gets disrupted when shocks hit, that can adversely affect the rest of the financial system or, increasingly, the broader economy.

In fact, in recent years, we have seen incidents – at a global level – where external shocks resulted in a significant disruption in core markets.

For example, in March 2020, amid a sudden 'dash for cash', there was severe disruption in a range of global markets, including short-term funding markets, longer-term corporate debt markets and even sovereign debt markets.[6]

And, last year, we saw an abrupt disruption in the Gilt market in the UK, with evaporating market liquidity and a sharp spike in Gilt yields. This episode had significant and persistent adverse spillovers for other market participants and the broader UK economy.[7]

Of course, in both of these instances, what triggered the stresses were exogenous events.

In the former case, the onset of a global pandemic, which the world had not experienced in about a century. In the latter case, market perceptions of a shift in fiscal policy in the UK.

But these exogenous events were amplified by vulnerabilities within the financial system.

Indeed, a common thread in both of these episodes was a spike in demand for liquidity due to asset sales by non-bank financial intermediaries in light of underlying financial vulnerabilities, including liquidity mismatch and leverage.

And, in both of these cases, returning to functioning markets required significant central bank interventions.

In essence, what these stresses demonstrated was insufficient resilience in segments of the financial system, or – put differently – insufficient private self-insurance *ex ante.*

And the eventual outcome was a need for public interventions *ex post.*

This is not an optimal outcome from a public policy perspective.

Central bank interventions are not cost free.

Depending on their design, they can interact with the monetary policy stance. They can also entail risks to central bank balance sheets. And any market expectations of central bank interventions *ex post* can distort incentives of market participants to self-insure *ex ante.*

So these episodes – and the broader structural changes in the financial sector since the global financial crisis – raise important policy questions about how to strengthen resilience of markets.

Markets as an ecosystem

Markets are complex ecosystems, with a range of diverse participants.

At the end of the day, the dislocations experienced in markets during the above episodes were the outcome of large spikes in the demand for liquidity, which were not met by liquidity supply.

It is therefore very welcome that – at a global level and led by the Financial Stability Board (FSB) – these policy questions are being approached in a holistic way.

That work covers dimensions related to the observed spikes in demand for liquidity, especially by non-banks, for example where they needed to sell assets to meet investor redemptions (such as money market funds or open-ended funds) or unwind leveraged positions (such as LDI funds).

And it also covers dimensions related to the supply of liquidity in markets, including through the FSB's work on liquidity in core government bond markets and IOSCO's work on liquidity in corporate bond markets.[8]

While no single policy initiative on its own will be a silver bullet, it is important that momentum to strengthen resilience of markets is maintained.

That will enable market-based financing to fulfil its role as a valuable and sustainable source of financial intermediation for the broader economy.

A missing ingredient in the regulatory framework for NBFI: the macroprudential perspective

Let me now focus on one specific dimension of the broader policy agenda: strengthening resilience of non-bank financial intermediation.

This is at the forefront of our own thinking at the Central Bank of Ireland, given the size of the non-bank financial intermediation sector, especially asset management, based in Ireland.

The area of non-banks is one where an evolution in the regulatory approach is likely required over time.

The regulatory framework at the moment is very much founded on – and has been mainly designed around – the protection of investors.

While this dimension is critical, the impact of non-bank financial intermediation is much broader than on their own investors.

In the face of adverse shocks, vulnerabilities in non-banks can trigger or amplify broader market stresses, with adverse implications for the broader macro-economy.

So complementing the investor protection perspective, an additional perspective is needed in regulation: one that is macroprudential in focus.

Let me be clear. Financial stability and investor protection are entirely complementary objectives.

Investors can suffer if markets are not resilient and liquidity disappears in times of stress, when it may be needed most.

And financial intermediaries operating in the best interests of investors, safeguarding the integrity of markets, is a necessary precondition for financial stability.

To illustrate the point around complementarity of objectives with a more practical example, take the global policy discussions around anti-dilution tools for open-ended funds.[9]

These entail positive investor protection benefits, by ensuring that redeeming investors bear the cost of redeeming shares in open-ended funds.

And they can also entail positive financial stability benefits, by guarding against first-mover advantage dynamics in light of liquidity mismatches in segments of the open-ended funds sector.

Towards a macroprudential perspective in the regulation of funds: some guiding principles

Developing such a macroprudential perspective in the regulation of non-banks can strengthen the resilience of markets.

But I fear that when people hear the words 'macroprudential' they immediately think of banks.

Let me be clear on this too. A macroprudential perspective in the regulation of non-banks does not mean applying the same approach as we have for the banking system.

Banks are very different to non-banks, and seeking to transpose the existing banking framework to other parts of the financial system will not be effective.

So how might we approach this instead?

Let me offer some principles that can guide the way forward.

I'll do this with a focus on the investment fund sector, partly because this is a sector where we have particular expertise in regulating and supervising in Ireland, but also because it has grown significantly in systemic importance at a global level in recent years.

1. Focus on cohorts of funds

The funds sector is very diverse, with many different types of business models. So there cannot be a 'one-size-fits-all' approach across the sector.

Moreover, in many cases, an individual fund is less likely to be systemically important.

There are thousands of funds, which – individually – may not matter for the rest of the financial system or the economy.

But the collective impact of correlated behaviour across a cohort of funds, especially in the face of similar underlying vulnerabilities, can have a material impact on market outcomes.

Indeed, what are individually rational actions by individual funds can – collectively – lead to disruptions in core markets.

A single LDI fund that has taken on substantial leverage through repo or derivatives could perhaps sell assets in the face of market volatility, without materially affecting market outcomes.

But, in aggregate, across all LDI funds with similar vulnerabilities, the impact of correlated actions can – and has – led to destabilising markets.

2. Aim to limit underlying vulnerabilities before shocks hit

While the funds sector is very diverse, with activities that are very different to banks, this does not mean we start from a blank sheet of paper.

We know where to look.

Time and time again in the history of financial stresses, some key sources of financial vulnerabilities appear.

The first is leverage. The second is liquidity transformation. And, when shocks hit, they can transmit through interconnectedness to different segments of the financial system.

So an underlying focus of a macroprudential perspective would be to identify and mitigate those vulnerabilities ex ante.

That focus needs to be particularly pronounced when funds are key participants in core markets.

3. The regulatory framework needs to reflect the evolving risk environment

A key feature of the financial system is that the nature and magnitude of risks evolves over time. This could be for either structural or cyclical reasons.

For example, a gradually growing importance of the fund sector in a given core market would be a structural factor that implies that a disruption in that form of financing could have a greater impact on the functioning of that market in times of stress.

From a cyclical perspective, history points to periods of time when financial market participants tend to under-price risk, only for that to reverse sharply in periods of stress.

In that context, and to be effective from a macroprudential perspective, the regulatory approach cannot deliver static outcomes. It needs to reflect the evolving risk environment.

4. International coordination is critical

Capital markets are very international in nature, which of course in itself entails significant benefits for the global economy.

But it also means that international co-ordination in regulation is critical.

Otherwise risks could just shift across borders, which can limit effectiveness of any regulatory approach.

Moreover, the actions by one jurisdiction can have a direct impact on financing conditions of another jurisdiction.

Ultimately, financial stability is a global public good. Everyone benefits from resilient global markets.

So developing policies to strengthen resilience of non-banks at a global level – as per the agenda of the FSB and IOSCO – is optimal.

Conclusion

Substantial reforms to the regulation and supervision of banks since the global financial crisis have resulted in a more resilient banking system.

While banks remain at the core of the financial system, market-based finance has continued to grow in importance, both in Europe and at a global level.

This evolution of the financial system can entail significant benefits for the broader economy. But for those benefits to be realised fully, markets need to be resilient to stresses.

Further steps need to be taken to strengthen the resilience of segments of the non-bank financial system, including by developing a macroprudential lens in the regulation of non-banks.

Achieving that would require developing a regulatory approach that:

- Focuses on cohorts of the non-bank sector;
- Aims to limit vulnerabilities before shocks hit;
- Ensures that regulatory outcomes reflect the evolving risk environment; and,
- Crucially, is co-ordinated at a global level.

Ultimately, that will better serve both investors and the broader economy.

Thank you for your attention and I look forward to the panel discussion.

[1] I would like to thank Mark Cassidy, Gerry Cross, Patricia Dunne, Patrick Haran, Neill Killeen and Cian Murphy for their helpful comments.

[2] See, for example, Allen and Gale (2000) 'Comparing financial systems'.

[3] Based on data collected by the Financial Stability Board as part of the 'Global monitoring report on non-bank financial intermediation'.

[4] European Systemic Risk Board (2022) 'NBFI Monitor'.

[5] See Daly et al (2023) 'The growing role of investment funds in euro area real estate markets: risks and policy considerations' for the Euro Area and CBI (2022) 'Macroprudential measures for Irish property funds' for the equivalent share in Ireland.

[6] See, for example, Financial Stability Board (2020) 'Holistic review of the March market turmoil'; Liang (2020) 'Corporate bond market dysfunction during COVID-19 and lessons from the Fed's response'; Claessens and Lewrick (2021) 'Open-ended bond funds: systemic risks and policy implications'; and Dunne et al (2022) 'Financial fragility in open-ended mutual funds: the role of liquidity management tools'.

[7] See, for example, Pinter (2023) 'An anatomy of the 2022 Gilt market crisis'.

[8] See Financial Stability Board (2022) 'Liquidity in core government bond markets' and IOSCO (2022) 'Corporate bond markets – Drivers of liquidity during Covid-19 induced market stresses'.

[9] See Financial Stability Board (2022) 'Assessment of the effectiveness of the FSB's 2017 Recommendations on liquidity mismatch in open-ended funds'.