

Stress and resilience in international capital markets



by **Paul Richards**

Summary

This Quarterly Assessment considers stress and resilience in international capital markets in Europe, taking account of recent official sector initiatives both in Europe and at global level. The tightening of monetary policy by central banks through the rise in short-term interest rates, which has been necessary to control inflation, has complicated the task for central banks in ensuring financial stability. So the assessment considers, first, the review by the authorities of financial stability in response to stress in the banking system in the spring of 2023; second, the steps being considered by the authorities to strengthen the resilience of the non-bank financial sector; third, the risk to resilience from market fragmentation as a result of regulatory divergence; and finally, the contribution that market firms themselves can make to strengthening resilience in international capital markets.

Monetary policy

1 There are different views on why inflation rose in Europe and the US in 2021 and 2022 to the highest levels for around 40 years: whether this was caused by a long period of exceptionally low interest rates, accompanied by high fiscal deficits and extensive quantitative easing (QE) during the pandemic; or by strong labour demand accompanied by relatively low unemployment after the pandemic; or by the impact of the Russian invasion of Ukraine on energy and food prices and by “friend-shoring” of fragile international supply chains against a background of continuing global tension; or by a combination of all these factors.

2 Whatever the reasons for the rise in inflation, the US Federal Reserve, the European Central Bank (ECB) and the Bank of England agreed on a similar monetary policy response: that they needed to restore price stability by bringing inflation back to the target levels of around 2% in their mandates (and not to recommend raising or suspending these target levels); and that bringing inflation back to target required a substantial tightening of monetary policy by raising short-term interest rates in 2022 and 2023. The three central banks have also indicated that the rise in short-term interest rates needs to be sustained for as long as necessary in order to bring inflation back to target on a permanent rather than just a temporary basis. This approach

by the three central banks has been characterised as “higher for longer”. Although current economic conditions and the economic outlook in the US, the EU and the UK are not the same, in all three cases significant progress has been made in reducing inflation (Chart 1), and capital markets have begun to anticipate that the peak in short-term interest rates may have been reached. But it is not yet clear that the battle to restore price stability has been won.

Chart 1: Inflation in the US, euro area and UK: 2009-2023



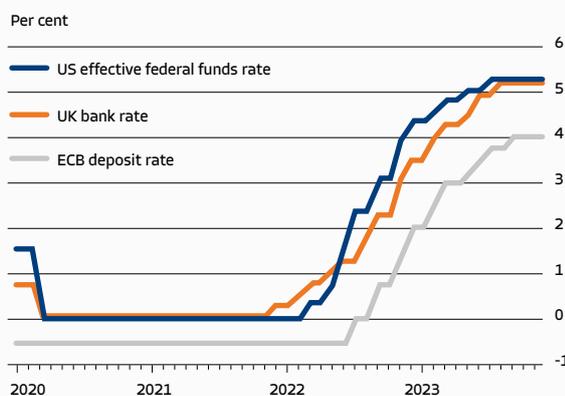
Note: annual percentage change in consumer price index.

Sources: LSEG, FT

Financial stability in the banking system

3 While the rise in short-term interest rates set by the three central banks (Chart 2) has been necessary to curb inflation, it has complicated the other key task of the three central banks, which is to ensure financial stability. Short-term interest rates are not high in historic terms, but the rise from exceptionally low interest rates has been rapid, and it has been accompanied by a substantial net increase in bond yields along the yield curve. This has increased the cost of financing and refinancing at a time when the stock of debt is already at a high level in both the public sector, in response to fiscal deficits (in particular during the pandemic), and the private sector, with implications for credit quality. And where central banks are replacing QE by quantitative tightening (QT) to reduce the size of their balance sheets, this increases the amount of public sector debt issuance that the private sector needs to absorb. The net rise in bond yields has resulted in capital losses for both central banks and commercial banks on their existing holdings of government debt, when marked to market. Against this background, four of the most vulnerable commercial banks – three regional banks in the US and Credit Suisse in Europe – were subject to bank deposit runs in the spring of 2023.

Chart 2: Short-term interest rates set by the Federal Reserve, ECB and Bank of England: 2020–2023



Note: %. Sources: Eurostat, US Federal Reserve, ECB, Bank of England, FT

4 In response, the Financial Stability Board (FSB) has reviewed the operation of the framework for international bank resolution to see whether there are lessons to be learned. The review has concluded that “recent events demonstrate the soundness of the framework”, as “the strains faced by individual banks did not cascade into a full-blown crisis”. But there are still lessons to be learned:

- The FSB has noted that a striking feature of the recent bank failures was the unprecedented speed and scale of deposit runs. So it is “assessing vulnerabilities from asset-liability and liquidity mismatches and exploring whether technology and social media have changed deposit stickiness”.
- The FSB has also emphasised that “banks’ risk management and governance arrangements remain the first and most important source of resilience”. So the Basel Committee on Banking Supervision (BCBS) is prioritising work to strengthen supervisory effectiveness.¹ The FSB has also emphasised that banks need to have sufficient sources of funding and internal liquidity resources and be prepared to mobilise collateral in resolution.²

5 While the authorities’ focus is on making sure that banks are safe and sound, this does not equate to a “zero-failure” regime, as the authorities want banks to continue to provide useful services such as lending which involve significant risks.³

Financial stability outside the banking system

6 The authorities are also concerned that, given their focus on regulating the banking system in response to the 2007/09 global financial crisis, the non-bank financial sector has grown to represent around half of global financial sector assets;⁴ and that one of the main reasons why the non-bank financial sector has grown so much and so fast is that it is more lightly regulated than the banks. In the authorities’ view, the non-bank financial sector has introduced important new sources of systemic risk.⁵

7 Originally, the non-bank financial sector was often described as so-called “shadow banking”, which appeared to cast doubt on its role. Recently, the term “non-bank financial

1. 2023 FSB Annual Report: *Promoting Global Financial Stability*, 11 October 2023.

2. 2023 FSB Resolution Report, *Applying Lessons Learnt*, 15 December 2023.

3. Sam Woods, CEO of the Prudential Regulation Authority and Deputy Governor for Prudential Regulation at the Bank of England: Mansion House, 16 October 2023.

4. Bank of England, *Market-Based Finance*, October 2023. The FSB reports that there was a slight reduction to 47.2% in 2022, mainly reflecting valuation losses, in the relative share of total global financial assets held by the NBFIs sector: 2023 edition of *Global Monitoring Report on NBFIs*, December 2023.

5. Andrew Hauser, Executive Director for Markets, Bank of England: *A Journey of 1000 Miles Begins with a Single Step: Filling Gaps in the Central Bank Liquidity Toolkit*, 28 September 2023.

institutions” (NBFIs) has increasingly been used. But this does not distinguish adequately between a range of very different types of financial institution: eg between asset managers and hedge funds or private equity. Some NBFIs are already regulated, while others are not. The Bank of England Financial Policy Committee uses the term “market-based finance” to describe its own area of focus.

8 Non-bank financial sector risks have been identified by regulators as a potential problem since at least the “dash for cash” in March 2020 at the outbreak of the pandemic. There have been other cases since: eg the failure of Archegos in March 2021; and the liability-driven investment (LDI) crisis in the UK in October 2022:

- The FSB has noted that the rise in interest rates could lead to higher volatility in asset prices; and it considers that this could generate significant spikes in collateral and margin calls which could induce fire sales of assets, as could liquidity mismatches in NBFIs.⁶
- The Bank of England Financial Policy Committee considers that market-based finance is subject to a number of risks, such as leverage, liquidity and maturity mismatch, and market features, such as interconnectedness and concentration, which make the sector and markets vulnerable to shocks.⁷

9 The policy approach which the authorities are taking in response to these risks is to identify and address systemic risks to financial stability across the non-bank financial sector as a whole, particularly where extensive use of leverage is involved, adopting the principle: “same activity, same risk, same regulation”.⁸ Their objective is to ensure that market-based finance is resilient enough to absorb shocks and not to amplify them.⁹ So, for example:

- the FSB and IOSCO have revised their policy recommendations and guidance to strengthen liquidity management by open-ended fund managers;¹⁰ the FSB

is also working with standard-setting bodies to enhance margining practices and has launched policy work on non-bank leverage; and it is consulting on a global standard to support the resolution of central counterparties (CCPs), given their systemic importance;¹¹

- the Bank of England is undertaking a “system-wide exploratory scenario” (SWES) exercise. The objective of the SWES is to assess the behaviour of banks and NBFIs during stressed financial market conditions, “and how they might interact to amplify shocks to markets core to UK financial stability”.¹² And the FCA is planning to review valuations in private markets.

10 In response to the LDI crisis, the Bank of England is also planning to tackle systemic risks in market-based finance by developing a central bank lending facility against high quality collateral for non-bank financial institutions subject to stress with a view to restoring stability, while incentivising NBFIs to improve their own risk management. The plans will start with pension funds and insurance companies, and they will require the support of market participants and regulators. They “will be designed to address dysfunction in core sterling markets in the exceptional circumstances where there is a threat to UK financial stability.”¹³

11 It is clear that a wide range of different initiatives are being considered by the authorities in the interests of ensuring financial stability in the non-bank financial sector. The authorities need to adopt an integrated approach, as the market is interconnected. Regulating one particular part of the market may have unintended consequences elsewhere. Where regulations are designed to have an extra-territorial impact, this is another complicating factor.

The risk of market fragmentation

12 An additional risk to the resilience of international capital markets is the risk of market fragmentation as a result of regulatory divergence between different jurisdictions.¹⁴ The

6. 2023 FSB Annual Report, *Promoting Global Financial Stability*, 11 October 2023.

7. Bank of England Financial Policy Committee, *Market-Based Finance*, October 2023.

8. The US Financial Stability Oversight Council has also finalised new guidance easing its ability to designate NBFIs as systemically important and to place them under Federal Reserve supervision, November 2023.

9. Bank of England Financial Policy Committee, *Market-Based Finance*, October 2023.

10. FSB and IOSCO published policies to address vulnerabilities from liquidity mismatch in open-ended funds on 20 December 2023.

11. 2023 FSB Annual Report, *Promoting Global Financial Stability*, 11 October 2023.

12. Bank of England Financial Stability Report, 6 December 2023. In addition, the UK authorities have launched a consultation on enhancing MMF resilience measures.

13. Andrew Hauser, Executive Director for Markets, Bank of England: *A Journey of 1000 Miles Begins with a Single Step: Filling Gaps in the Central Bank Liquidity Toolkit*, 28 September 2023. The FSB also “plans to review whether existing public sector backstops are adequate for the range of potential failure scenarios”: 2023 FSB Resolution Report, 15 December 2023.

14. See, for example, Maros Sefcovic, Vice-President of the European Commission: “Over time, increased divergence may bring even more costs and will further deepen the barriers to trade between EU and the UK.”: EU-UK Forum Annual Conference, 12 June 2023.

President of the ECB has said that “there are increasing signs that the global economy is fragmenting into competing blocs.”¹⁵ The risk of market fragmentation that needs to be addressed takes many forms. At *global* level, for example:

- the FSB has concluded that the stress in the banking system in March 2023 underscores the importance of completing the implementation of outstanding Basel III standards in full, consistently and as soon as possible, but has noted that implementation in many cases is being pushed to 2024 or a later date;¹⁶
- the transition from T+2 to T+1 in the settlement cycle in the US in May 2024 has raised concern in the EU and the UK about whether, and if so when, they should follow the US, as the transition from T+2 to T+1 is likely to be more complex and take significantly longer in the EU and the UK, leading to the co-existence of different settlement cycles in different jurisdictions during any transition period;
- the FSB is working with the International Sustainability Standards Board (ISSB), IOSCO and other bodies to promote the timely and wide use of the ISSB’s inaugural sustainability disclosure standards as well as their interoperability with jurisdictional frameworks so as to achieve global comparability of climate-related disclosures;¹⁷ and
- the FSB is focusing on the global implementation of its recommendations on a regulatory framework for crypto-assets, including stablecoins, based on the principle of “same activity, same risk, same regulation”; and has issued recommendations to achieve greater convergence in cyber incident reporting.¹⁸

13 At *European* level, since the end of the post-Brexit transition period, EU and UK regulation of financial services have begun to diverge in two main ways. First, the UK is changing its regulatory process by devolving detailed rulemaking powers to the FCA and the PRA under the Financial Services and Markets Act 2023, while maintaining their accountability to Parliament in the UK. This is intended to give UK regulation greater agility than the EU, where regulations have to be applied in the same way in 27 different Member States, with the result that the text of legislation takes time to agree and implement and more

time subsequently to review and reform. Second, the UK is also making changes to the substance of the rules inherited from the EU. While the UK Government is not pursuing regulatory reform for its own sake, it *is* proposing regulatory divergence from the EU where it believes that this meets the needs of UK financial services and markets.¹⁹ As EU regulations are themselves changing, and not necessarily changing in the same direction as the UK,²⁰ both the UK and the EU will diverge from the previous regulatory regime.

14 Within the EU, Banking Union and Capital Markets Union are closely related projects which both still represent work in progress. Banking Union remains incomplete, as the EU banking sector is still segmented along national lines. In particular, political agreement on a European deposit insurance scheme, which would involve joint and several guarantees for up to €8 trillion of insured deposits, has not yet been achieved. The Chair of the Supervisory Board of the ECB has argued that “an incomplete Banking Union is the reason why cross-border banking groups are ring-fenced along national lines and cross-border integration does not happen. But the absence of cross-border integration is one of the fundamental reasons why the Banking Union cannot be completed.” He has concluded: “The harsh reality is that the lack of integration creates a dangerous fault line in our institutional set-up, and this cannot be fixed by effective supervision alone. But if the system breaks down again, repairing it could prove to be very difficult and expensive.”²¹

15 In order to complete Capital Markets Union (CMU), there are still some fundamental issues which have yet to be resolved at EU level. These involve addressing legislative differences at national level, such as different tax and insolvency regimes, as well as reforming pensions and improving financial literacy, which are a national responsibility. In this context, the President of the ECB has proposed that the EU should create a European equivalent of the US Securities and Exchange Commission (SEC), for example by extending the powers of ESMA, which “would need a broad mandate, including direct supervision, to mitigate systemic risks posed by large cross-border firms and market infrastructures such as EU central counterparties. To mitigate fragmentation in EU capital markets, a more ambitious approach should involve the creation of a single rulebook enforced by a unified supervisor.”²²

15. Christine Lagarde, President of the ECB: *A Kantian Shift for the Capital Markets Union*, European Banking Congress, Frankfurt, 17 November 2023.

16. 2003 FSB Annual Report, *Promoting Global Financial Stability*, 11 October 2023.

17. Ibid.

18. Ibid.

19. See ICMA, *The UK’s Future Regulatory Framework Review in a Global Context*, ICMA Quarterly Report, Third Quarter 2023.

20. eg Compare the EU Listing Act with the UK prospectus regime.

21. Andrea Enria, Chair of the Supervisory Board of the ECB: *Exogenous Shocks and Endogenous Challenges: Five Years of European Banking Supervision (and Beyond)*: London, 30 October 2023.

22. Christine Lagarde, President of the ECB: *A Kantian Shift for the Capital Markets Union*: European Banking Congress, Frankfurt, 17 November 2023.

16 This “top-down” proposal needs to be assessed in the context of an EU debate about whether sufficient progress towards CMU is being made through incremental improvements in the structure of EU capital markets “bottom-up”.²³ The “top-down” and “bottom-up” approaches are not necessarily mutually exclusive. But implementation of the “top-down” approach depends on the willingness of Member States to make hard political choices, whereas the “bottom-up” approach may help EU capital markets to develop without necessarily leading to CMU. It is notable that ESMA has set up a taskforce which is considering ways of enhancing the effectiveness and attractiveness of EU capital markets and which is due to report in public in May 2024.²⁴

17 There is also a question about whether CMU can be completed without the creation of a central euro safe asset: the equivalent in the EU of US Treasuries. The EU is already an issuer in capital markets in its own right. But interest rate spreads remain between the debts of national governments in the euro area reflecting their respective credit standing. While the former President of the ECB said in response to the sovereign debt crisis in the euro area in 2012 that the ECB would do “whatever it takes” to preserve the euro, national governments in the euro area do not stand behind each other’s debts.²⁵ The current President of the ECB has said that “this should not stop us from working on the many other areas that are necessary for CMU to become a reality”.²⁶

18 It is not yet clear whether the EU will focus on creating a CMU only for financial institutions located within the EU, with barriers for institutions located in third countries, or whether and on what basis the EU market is going to become more open globally. An EU location policy is designed to make it easier for the EU authorities to ensure financial stability within the EU, though ensuring financial stability in international capital markets is an international concern. A location policy also raises questions about its potential impact on international competitiveness, as it is more expensive for international market firms to run two separate operations (eg in the EU and the UK) than in the equivalent of a single market encompassing them both.

19 In the case of relations between the EU and the UK as a third country, the EU/UK MOU on regulatory cooperation, for which the first semi-annual meeting between officials on the two sides took place on 19 October 2023, provides a way of sharing regulatory information. It does not necessarily imply that grants of regulatory equivalence for the UK from the EU

will be forthcoming in future.²⁷ Even so, both the EU and the UK are committed to continuing to comply with high international standards (set through the FSB, BCBS and IOSCO). Decisions relating to the regulation of financial services at global level need to be implemented by member jurisdictions at both EU and UK level, and in a broadly consistent way.

The market’s own contribution to strengthening resilience

20 Ensuring financial stability is not just a matter for the authorities alone. It is also a matter for international capital market firms to do what they can to strengthen the resilience of the financial system, both through good governance and risk management in their own institutions and by taking steps to improve market liquidity, transparency and efficiency, where this is feasible. Some of the steps to strengthen the resilience of international capital markets involve extensive cooperation between the market and the official sector. The transition from LIBOR to near risk-free rates is a good example of cooperation between the market and the official sector globally to reduce the financial stability risks arising from US\$400 trillion of LIBOR contracts across the global financial system. The initiative in the US to improve settlement efficiency by shortening the settlement cycle from T+2 to T+1 is also likely to require international cooperation, as any change in the EU and the UK would be more complex and take significantly longer than in the US.

Conclusion

21 In developing the G20 reforms in the aftermath of the 2007/09 global financial crisis, the authorities recognised the benefits of international standards in promoting confidence in the financial system and the resumption of cross-border financial activity. The FSB has warned that “maintaining this level of cooperation is critical, given the challenging combination of rapidly evolving financial conditions and structural change in the financial system brought about by the growth of NBFIs, accelerating digitalisation and climate change.”²⁸ Market firms and their trade associations also have an important role to play in reducing the risk of stress by strengthening resilience in international capital markets.



Contact: Paul Richards
paul.richards@icmagroup.org

23. See, for example, Paschal Donohoe, President of the Eurogroup: “By adopting a more bottom-up approach and sharing best practices, domestic regulation could be harmonised in the near-term, in advance of EU level regulation being adopted and implemented.”: 20 October 2023.

24. Terms of reference of ESMA *Task Force on the Effectiveness of EU Capital Markets*, 24 October 2023.

25. See the Maastricht Treaty on European Economic and Monetary Union.

26. Christine Lagarde, President of the ECB: *A Kantian Shift for the Capital Markets Union*: European Banking Congress, Frankfurt, 17 November 2023.

27. The only grant of EU equivalence to the UK at present relates to CCPs, which is due to end in 2025.

28. 2023 FSB Annual Report: *Promoting Global Financial Stability*, 11 October 2023.