How to address systemic risks stemming from the non-bank financial sector

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Disclaimer: Views are those of the presenter and do not necessarily reflect the views of the Central Bank of Cyprus.

1. Introduction
2. Sources of systemic risk from the non-bank financial sector
3. Policy options to address systemic risks from non-bank intermediation

1. Introduction

Systemic risk

"A *risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy.*" (IMF, BIS and FSB, 2009)

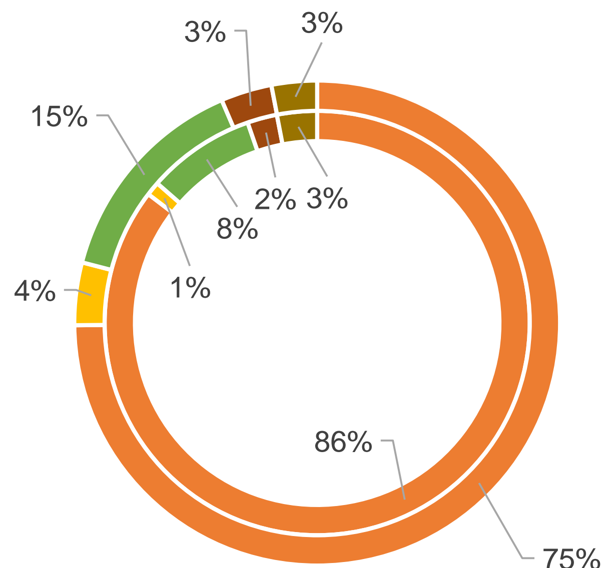
"A risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy." (The ESRB Regulation (2010))

Introduction

Cyprus Financial Sector (billion €)

	Dec-12	Dec-18
Monetary financial institutions	137	82
Investment firms	13	16
Non-money market investment funds	2	5
Insurance corporations	3	3
Pension funds	5	3
Total financial sector	**160**	**109**
Total non-bank financial sector	**23**	**27**
Cyprus GDP	19	21

Cyprus Financial Sector in 2012 (inner ring) and in 2018 (outer ring)

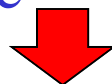


2. Sources of systemic risk from the non-bank financial sector

Sources of systemic risk from the non-bank financial sector

The financial system provides a range of critical services for the economy, such as:

- payments
- securities settlement
- clearing
- intermediating between savers and borrowers
- risk-sharing and insurance



Entities and activities in the non-bank sector provide services for the financial system and the real economy and are interconnected with systemically important institutions and important markets.

Sources of systemic risk from the non-bank financial sector

- Financial markets are made up of complex dynamic networks, which expand in good times but may break down in bad times.
- Most financial market infrastructures are systemically important.
- Reliance on less stable forms of funding and related mismatches between assets and liabilities can also occur in the investment funds industry.
- Insurance may also be systemically important

Sources of systemic risk from the non-bank financial sector

- Main risks and vulnerabilities identified in the non-bank financial system (ESRB, 2018):
  - Liquidity risk and risks associated with leverage among some types of investment funds.
  - Interconnectedness and the risk of contagion across sectors and within the non-bank system, including domestic and cross-border linkages.
  - Procyclicality, leverage, and liquidity risk created through the use of derivatives and securities financing transactions.

The non bank sector is not immune to market failures, externalities and systemic risks.

3. Policy options to address systemic risks from non-bank intermediation

Policy options to address systemic risks from non-bank intermediation

Instrument design for non-bank intermediation

	End borrowers (real economy)	Lenders (financial system)			
	Excessive leverage	**Credit growth**	**Excessive maturity/ liquidity mismatch and market illiquidity**	**Interconnectedness/ contagion**	**Misaligned incentives**
Entity-based ↑ Examples of instruments ↓ **Activity-based**	Limits on bank debt for households or corporates Limits on total debt for households or corporates (e.g. caps on LTI/ debt to EBITDA) Limits on mortgage/ leverage finance transactions (e.g. LTV caps, caps on leveraged loans), independent of the type of lender (e.g. bank or non-bank loan)	Capital/ leverage requirements by type of lender (possibly time-varying) Minimum or countercyclical margin and haircut requirements that apply to both centrally cleared and non-centrally cleared transactions	Requirements related to maturity / liquidity mismatch by type of lender (e.g. limits) Instruments for increasing the resilience against large outflows (including redemption fees and gates where appropriate)	Large exposure restrictions Diversification requirements	Systemic risk surcharges Recovery and resolution tools (RRPs) [1]

[1] While these measures are not strictly speaking of a macroprudential nature they typically have a macroprudential dimension which is reflected in their systemic wide stabilising effects.

Source: Macroprudential policy beyond banking: An ESRB strategy paper (July 2016)

Policy options to address systemic risks from non-bank intermediation

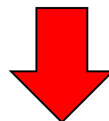
- Macroprudential instruments that apply to both lenders and borrowers, targeting entities and activities:
  - All forms of credit can contribute to credit booms and busts.
  - Currently, macroprudential tools are mainly applied to bank credit. However, certain macrorudential instruments, such as the LTV and the DSTI, can easily be applied to non-bank activities.
- Restrictions on large exposures, add-ons for systemically important institutions:
  - The Central Bank of Cyprus, in addition to the designation of 5 credit institutions as Other Systemically Important institutions (D-SIBs), designated 5 investment firms as Other Systemically Important institutions.

Policy options to address systemic risks from non-bank intermediation

- Margin and haircut requirements for derivatives (ESRB, 2017):
  - Margin and haircut practices can exacerbate systemic risks, by contributing to the build-up of excessive leverage in the financial system during upswings and deleveraging during downswings.
  - While regulatory requirements consider procyclicality risks, there is no explicit mandate for the use of margins and haircuts to meet macroprudential objective.
- The move to a more market-based financial system, underscores the need for a broader set of macroprudential instruments (ESRB, 2016).

Policy options to address systemic risks from non-bank intermediation

- Macroprudential instruments to address financial stability risks beyond the banking sector should be part of a wider macroprudential policy strategy (ESRB, 2016).
- Recent legislative changes and current policy discussions suggest a gradual evolution towards a more holistic approach to addressing systemic risk.
- Recent policy initiatives at the EU and the international level created a more comprehensive approach towards non-banking institutions.



Further strengthening of the macroprudential toolkit is warranted.

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Thank you

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