THE COVID-19 PANDEMIC- A FINANCIAL STABILITY PERSPECTIVE

Francesco Mazzaferro
Head of the Secretariat
European Systemic Risk Board

ABSTRACT

Report of the speech given by Francesco Mazzaferro, Head of the ESRB Secretariat, during the Belgian Financial Forum Webinar on May 27, 2021. Prepared by Frank Lierman, Chairman of the Editorial Board of the Revue bancaire et financière/Bank- en Financiewezen

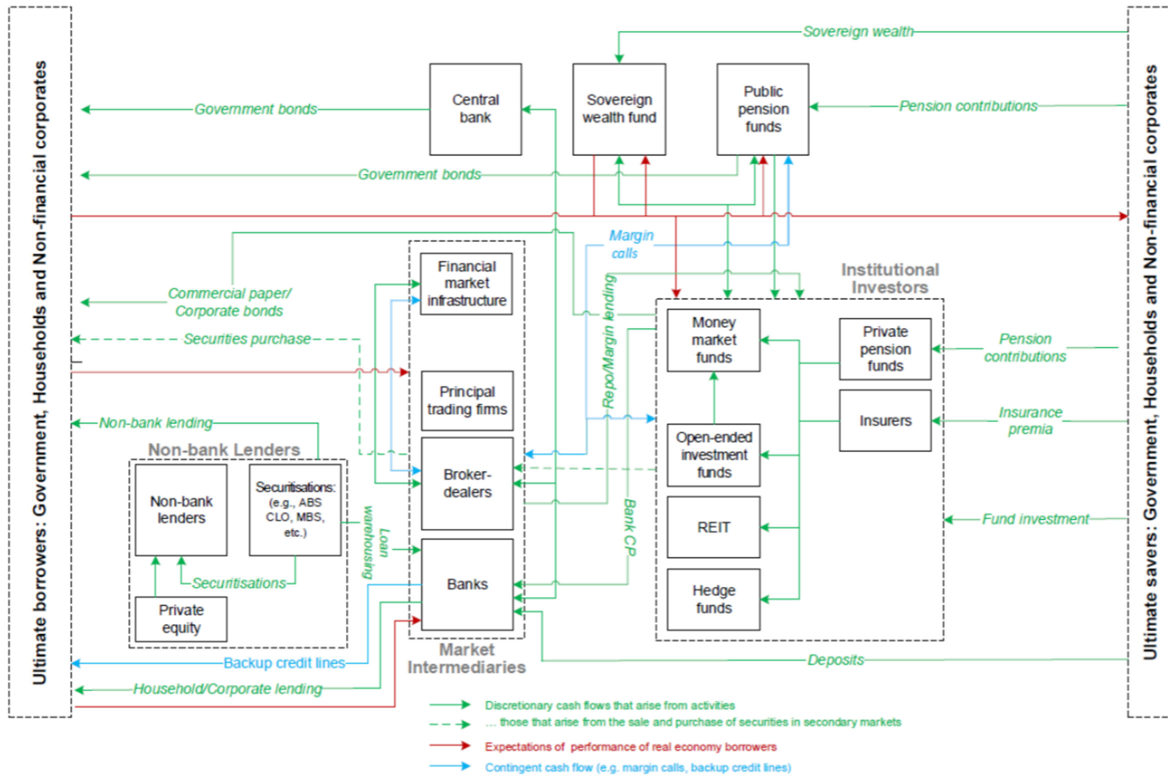
ARTICLE

The European Systemic Risk Board (ESRB) has been created in 2010 in response to the financial crisis. Its mission is the macroprudential oversight of the EU financial system to contribute to the prevention or mitigation of systemic risk to financial stability. The membership reflects the broad mission and includes EU central banks, entity and market supervisors, the European Supervisory Authorities, and the European Commission, as well as some eminent academics. The ESRB thus brings together a broad range of EU policy makers. To discharge its mission, the ESRB relies on soft law tools: “Warnings” and “Recommendations” to authorities and Member States of the EU which can be asked to act or to explain.

There is a long and complex chain of intermediation that connects ultimate savers and ultimate borrowers, which are government, households and non-financial corporates. The financial system is thus highly interconnected, which – during times of financial market stress – can lead to contagion.

This interconnectedness of the financial system covered is illustrated in figure 1.

Figure 1 - Interconnectedness of the financial system



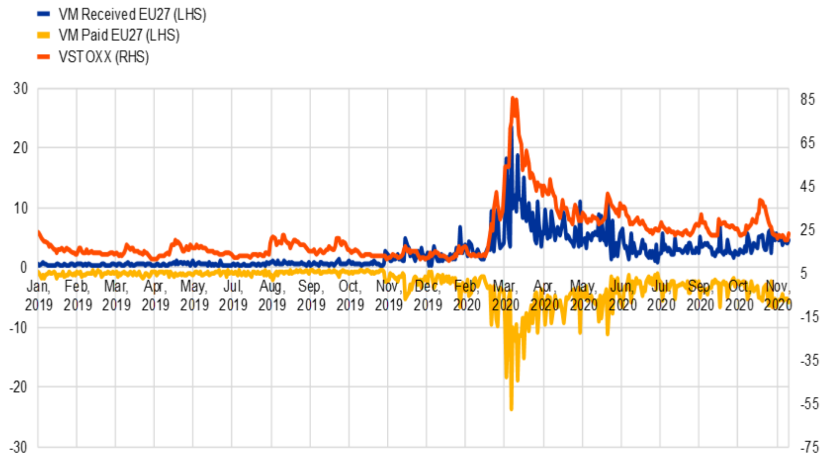
Source: FSB (2020)," Holistic Review of the March Market Turmoil", available at lhttps://www.fsb.org/wp-content/uploads/P171120-2.pdf

The outbreak of the COVID-19 pandemic led to an increase in investor risk aversion triggering a broad-based repricing of risk. This increase in risk aversion led to an increased demand for safe and liquid assets, notably cash. It created an imbalance in demand and supply with, for example, some segments of financial and non-financial corporate debt markets becoming increasingly illiquid.

This 'dash for cash' was accentuated by a sharp increase in payments to be made and received for variation margins on derivatives transactions. Initial margin - which is meant to be more stable than variation margin - also increased sharply

This increase in initial and variation margin is illustrated by the two charts in figure 2

[Figure 2](#) - The "dash for cash"



Sources: ESRB trade repository data and VSTOXX Public data plus ESRB Secretariat calculations.
Notes: The chart shows the daily flows of Variation Margin in EUR billions, that is the amount of VM received by CCPs from their clearing members and the amount that CCPs paid (back) to their clearing members.

Sources: ESRB trade repository data and VSTOXX Public data plus ESRB Secretariat calculations.
Notes: The chart shows the daily amount of Initial Margin held at EU27 CCPs in EUR Billions in relation to market volatility as expressed by the VSTOXX.

These margin calls had ramifications for other markets. For example, redemptions by Dutch insurer corporations and pension funds from money market funds (MMFs) were highly correlated with the incidence of net variation margin flows. The combination of investor redemptions and deteriorating

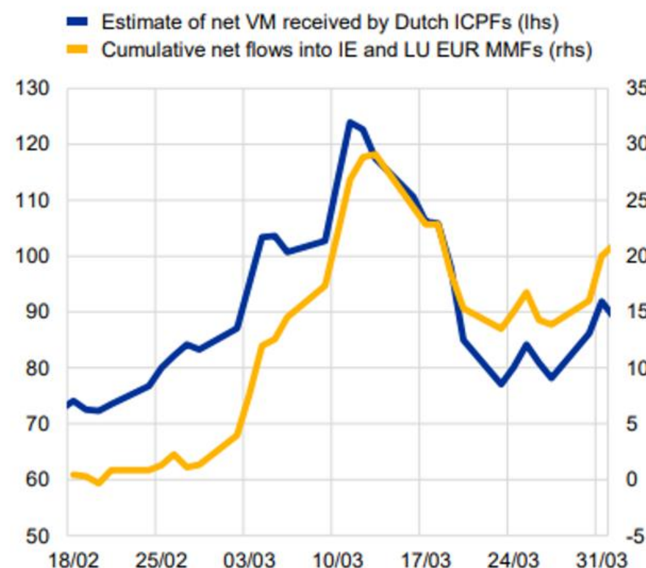
market liquidity of the assets held by investment funds, created liquidity management challenges at some types of money market funds and corporate bond funds.

With some of these developments reinforcing each other, there was a risk that impaired market functioning would adversely affect the ability of financial and non-financial firms to raise funds. This would ultimately have further weakened the economy.

To prevent this, central banks introduced extraordinary measures. This includes asset purchase programmes, special liquidity operations and US dollar funding facilities to restore market functioning and maintain the efficient transmission of monetary policy measures. These interventions were effective.

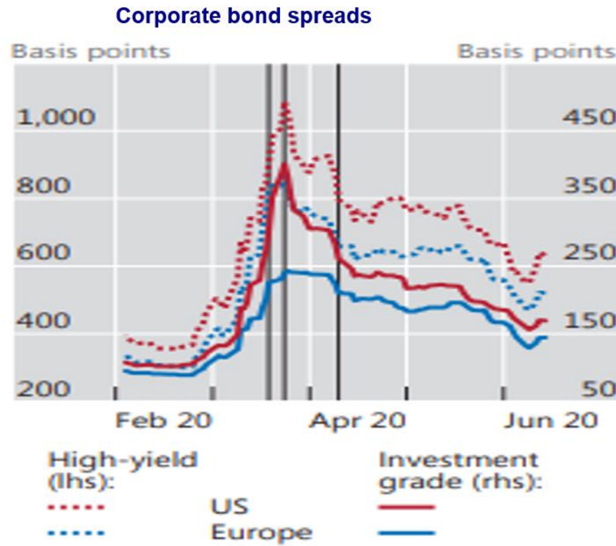
The impact of central bank interventions is illustrated by the charts in figures 3 and 4.

***Figure 3* - Ramifications for other markets**



Source: See European Central Bank (2020), 'Financial Stability Review', Box 8, November, available at https://www.ecb.europa.eu/pub/pdf/fsr/ecb.fsr202011~b7be9ae1f1.en.pdf

***Figure 4* - A monetary lifetime: central banks' crisis response**



Source: BIS Annual Economic Report, 30 June 2020, https://www.bis.org/publ/arpdf/ar2020e2.pdf
Notes: The vertical lines in the centre panel indicate 18 March (ECB announced Pandemic Emergency Purchase Programme (PEPP)), 23 March (Fed announced Primary Market Corporate Credit Facility (PMCCF) and Secondary Market Corporate Credit Facility (SMCCF)) and 9 April (Fed announced extension of eligible securities under PMCCF and SMCCF to include recently downgraded bonds)

The initial response of the ESRB to the pandemic can be split up into five priority areas as shown in figure 5.

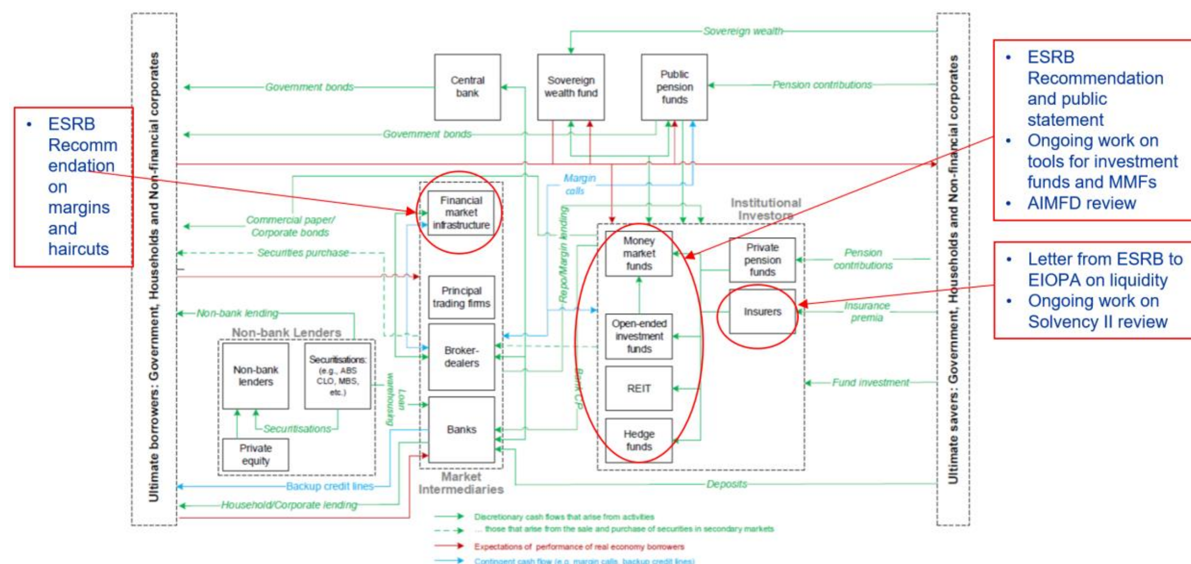
***Figure 5* – Five priority areas**

For further details see: https://www.esrb.europa.eu/home/search/coronavirus/html/index.en.html

This was a comprehensive response, covering banks, non-banks and the financial markets they operate in.

This is shown on the initial scheme in Figure 6 illustrating the broad range of activities and the complexity of the financial sector

Figure 6 – Interconnectedness of the financial system



Source: FSB (2020)," Holistic Review of the March Market Turmoil", available at lhttps://www.fsb.org/wp-content/uploads/P171120-2.pdf

It is evident that a market based financial intermediation is key. There is a clear need to go beyond pure banking activities. And the changing nature of finance means that entity-based regulation may not suffice when entities engage in a broad range of sometimes overlapping activities.

Some examples of excessive risk taking due to a search for yield and perhaps also dynamic entrepreneurship, could be considered as "snowflakes" but they could also be the starting point of a broader movement undermining the financial stability.

- Early 2021, the stock price of Game Stop jumped sharply without any fundamental news about the firm, causing large losses at some US hedge funds who had short positions.

- In March 2021, the US family office Archegos Capital Management was unable to meet variation margin calls on highly concentrated and leveraged positions on US and Chinese stocks. It was a source for major losses for prime brokers.
- In March 2021, Greensill as specialist in supply chain finance which filed for insolvency. There were ramifications for some banks, investment funds and insurers.
- In 2020, Wirecard was in the picture due to accounting fraud because the firm was always considered as a technology-firm and not as a bank, so regulation was not applicable initially.

Why did we not see these snowflakes? What is the blind spot? In fact, most of these cases fall between the “regulator” cracks, are not covered by the actual regulation and take profit of a kind of regulation arbitrage.

The main lesson is that a structural change in the regulation approach will be needed: if we cannot allocate firms as neatly between ‘entities’ anymore because they engage in a range of activities, we need to think about how we can reflect this in our regulation.

All in all, we need a global movement toward a congruent financial regulation, i.e. a macro prudential policy beyond banking. A review of the legal framework is unavoidable to improve the financial stability worldwide.