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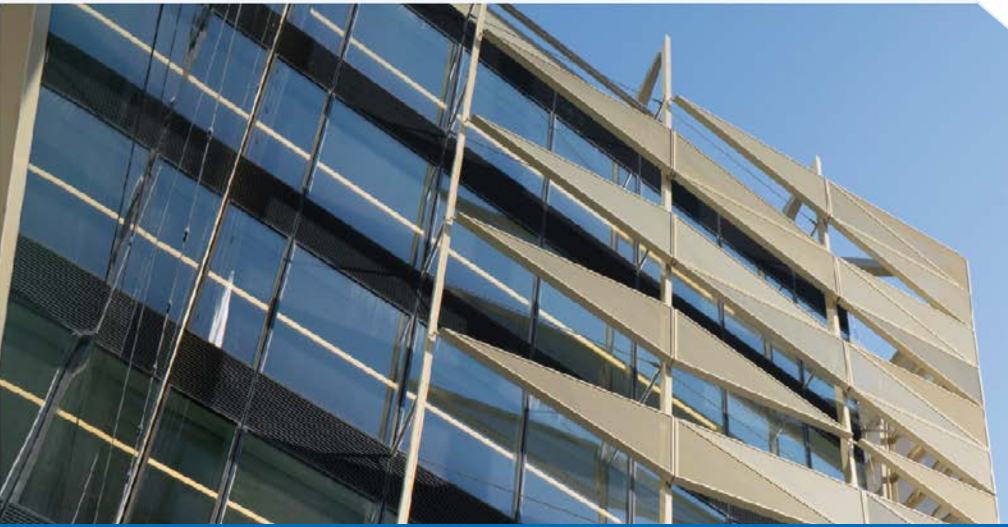


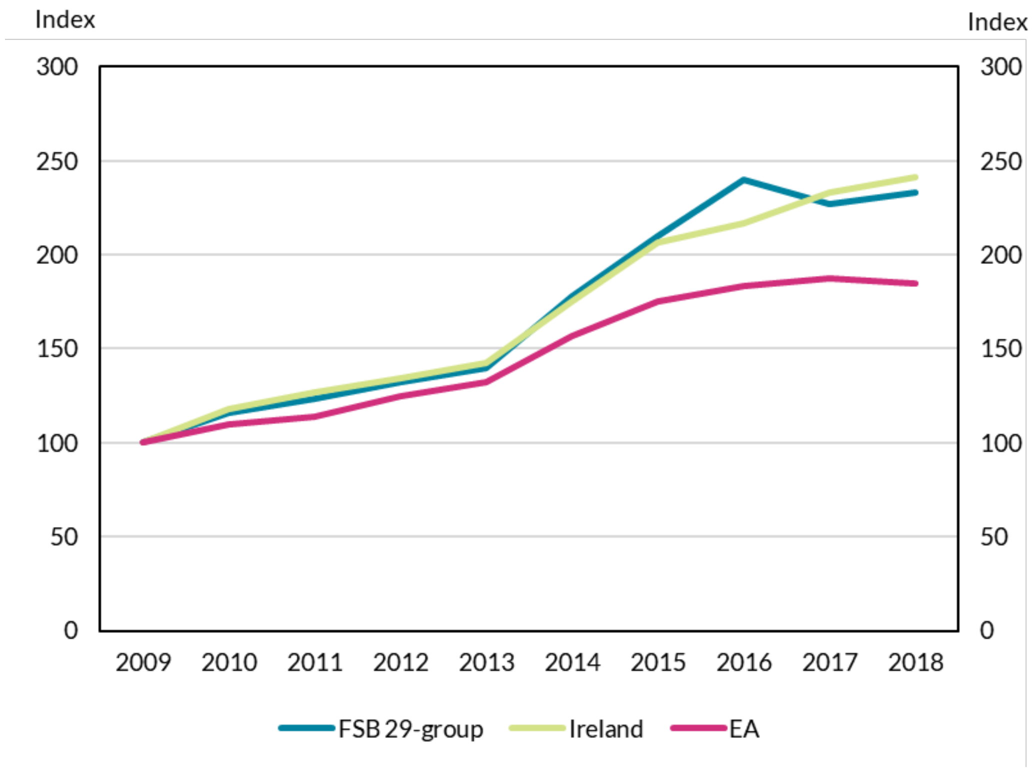
Making the case for macroprudential tools for the market-based finance sector: Lessons from COVID-19

Remarks by Governor Gabriel Makhlouf

29 June 2020

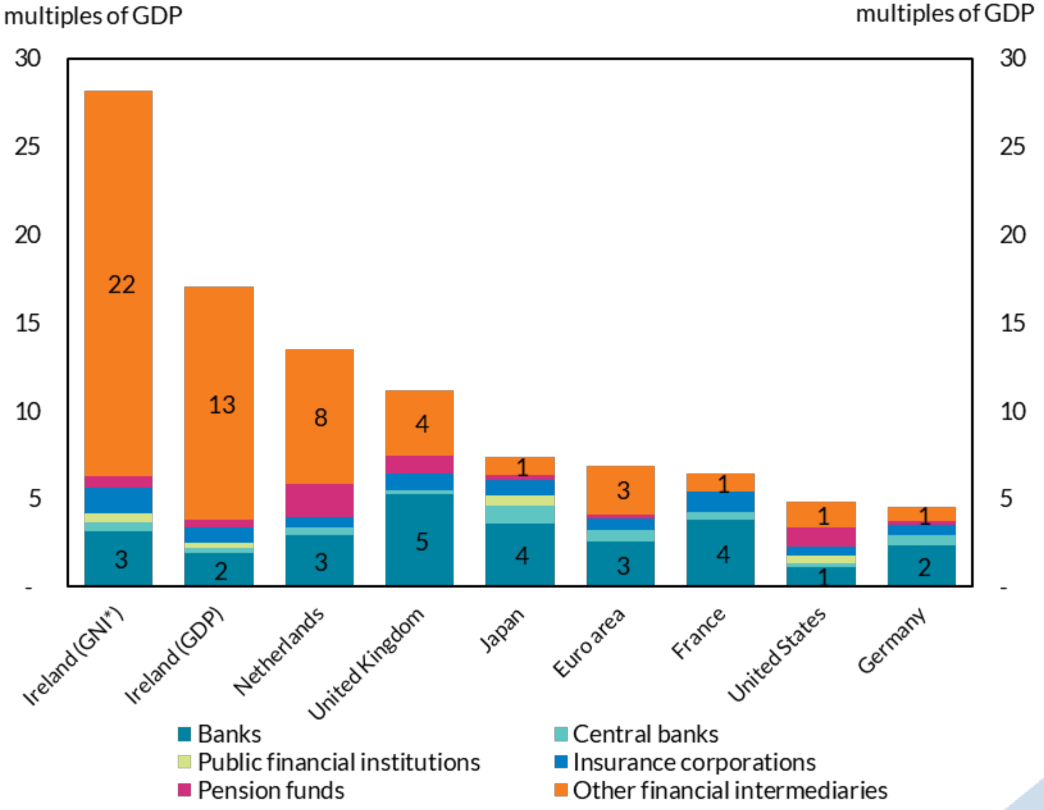
The market-based finance sector has grown rapidly in recent years

Comparative growth of the global, euro area and Irish market-based finance sectors (2009 – 2018)



Sources: FSB, ECB SDW, Central Bank of Ireland staff calculations.
Notes: Index = 100 for base year 2009.

Financial assets by institution type as a multiple of the country's GDP (GNI*) in 2018, selected countries



Source: FSB Global Monitoring Report on Non-Bank Financial Intermediation 2019, CSO, and Central Bank of Ireland staff calculations.

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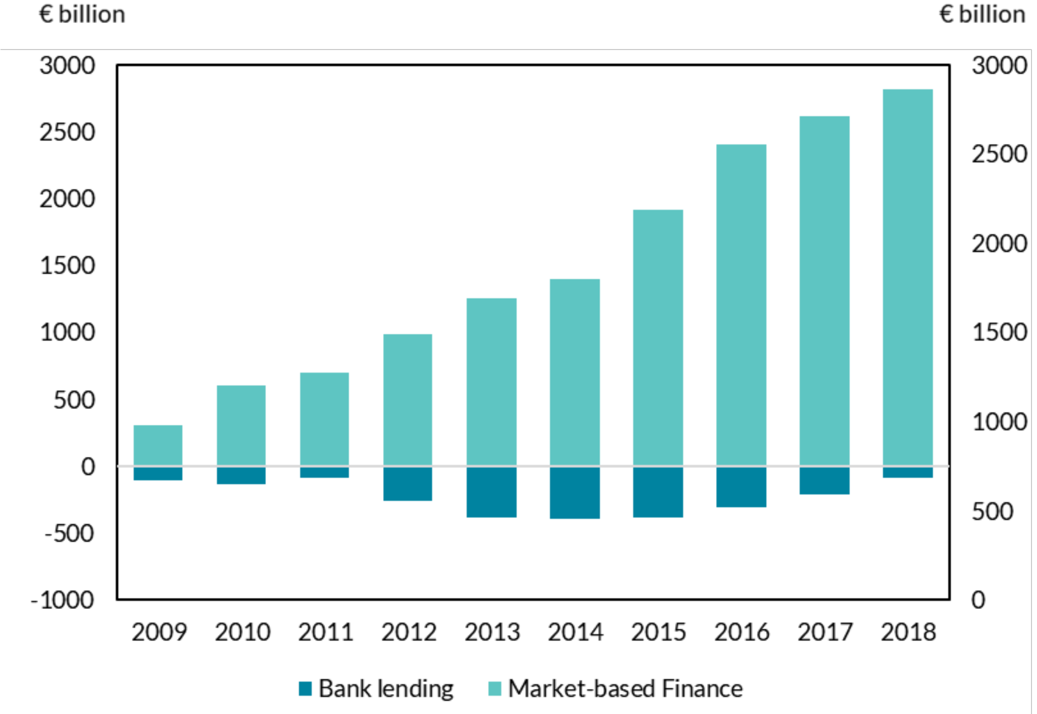
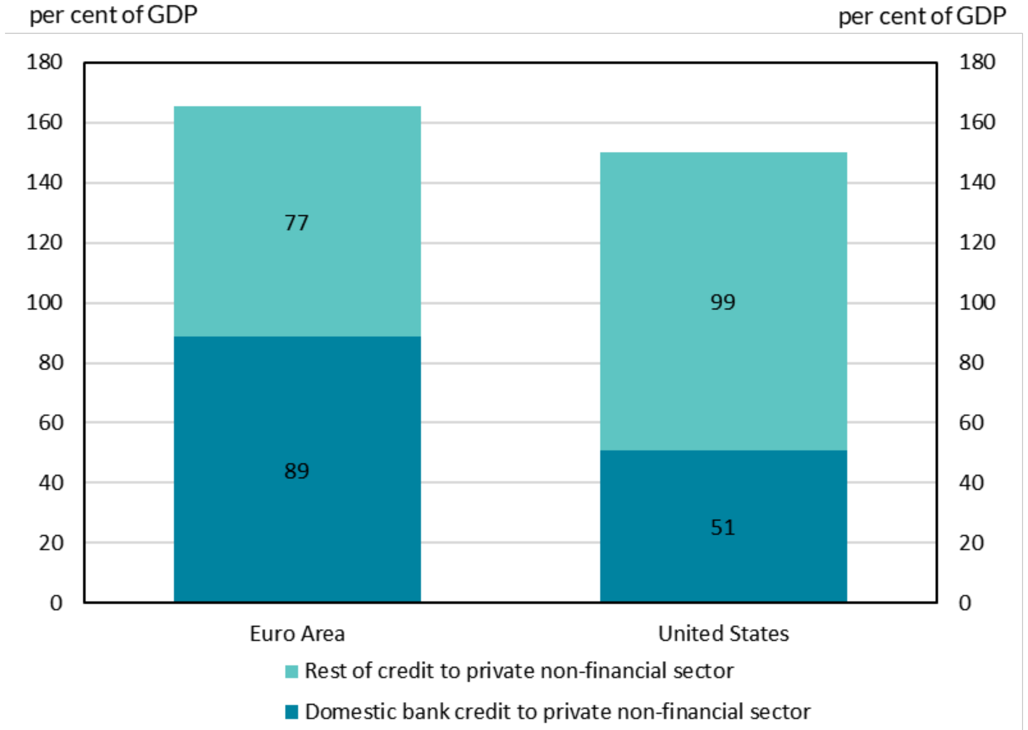
Resilient market-based sources of finance can support the economy

Cumulative net bank and market-based financing of euro area non-financial corporations, 2009 - 2018



Source: ESRB Non-Bank Financial Intermediation Risk Monitor 2019, ECB Quarterly Sector Accounts (QSA) & ESRB calculations.
Notes: "Market-Based Finance" includes financing through listed shares, unlisted shares and debt securities. Latest observation Q4 2018.

Credit to the private non-financial sector as a share of GDP, Q4 2019



Source: Bank for International Settlements.
Notes: The "private non-financial sector" includes non-financial corporations (both private-owned and publically-owned), households and non-profit institutions serving households as defined in the System of National Accounts 2008. In terms of financial instruments, credit covers loans and debt securities. Data as of Q4 2019.

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Structural vulnerabilities in the market-based finance sector can amplify shocks

Liquidity mismatches

Open-ended funds with short redemption periods and investments in less liquid assets could be susceptible to the risk of large redemptions in times of stress, requiring sales of less liquid assets over a short period of time.

Leverage

When asset prices fall in times of stress, highly-leveraged funds may seek to keep their leverage at a target level by selling assets over a short period of time or be forced to do so by their creditors.

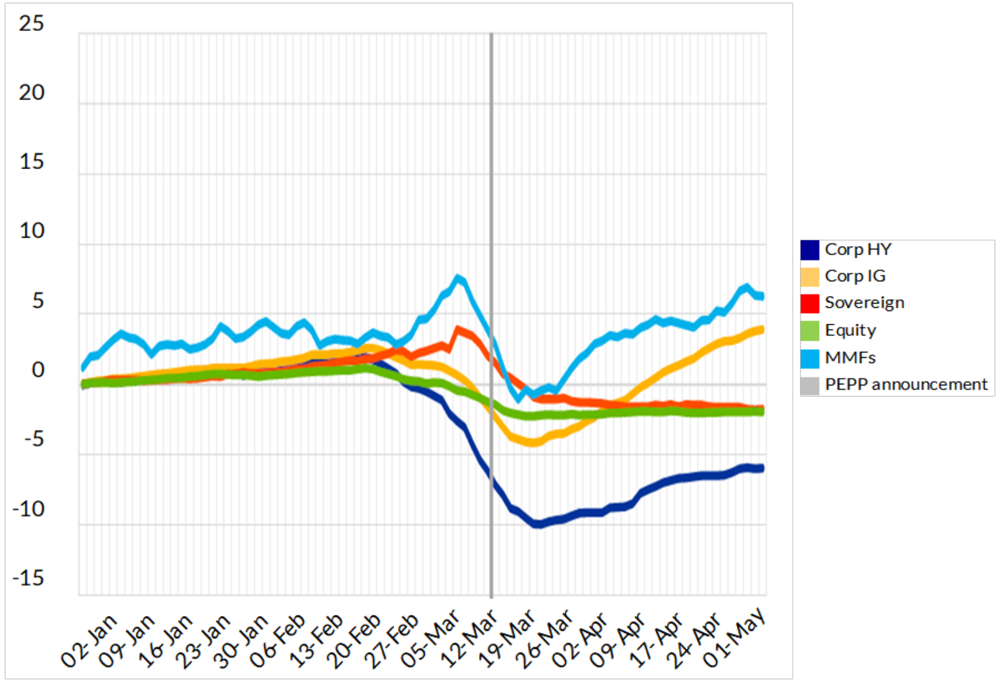
'Fire sale externalities'

Actions in response to shocks may be perfectly rational from the perspective of individual institutions but can have adverse, system-wide implications.

The onset of COVID-19 saw sharp redemptions from some types of funds and a deterioration in market liquidity conditions globally

Net flows into euro area domiciled funds

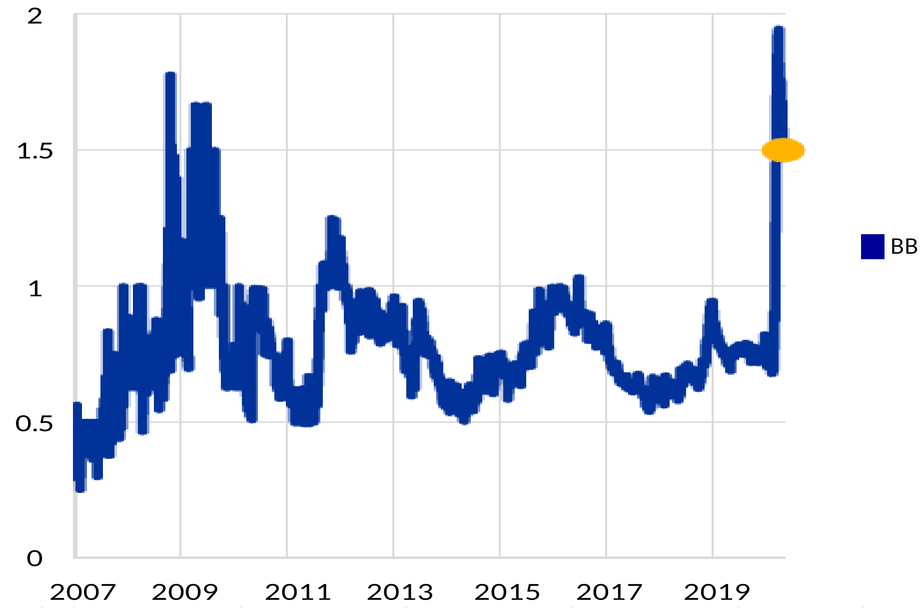
cumulative flows since start of 2020, % of AuMs



Sources: ESRB (2020a) "Issues note on liquidity in the corporate bond and commercial paper markets, the procyclical impact of downgrades and implications for asset managers and insurers", based on data from EPFR and ECB calculations.
Notes: Latest observations are for 7 May 2020.

Bid-ask spreads in euro-denominated high-yield NFC market

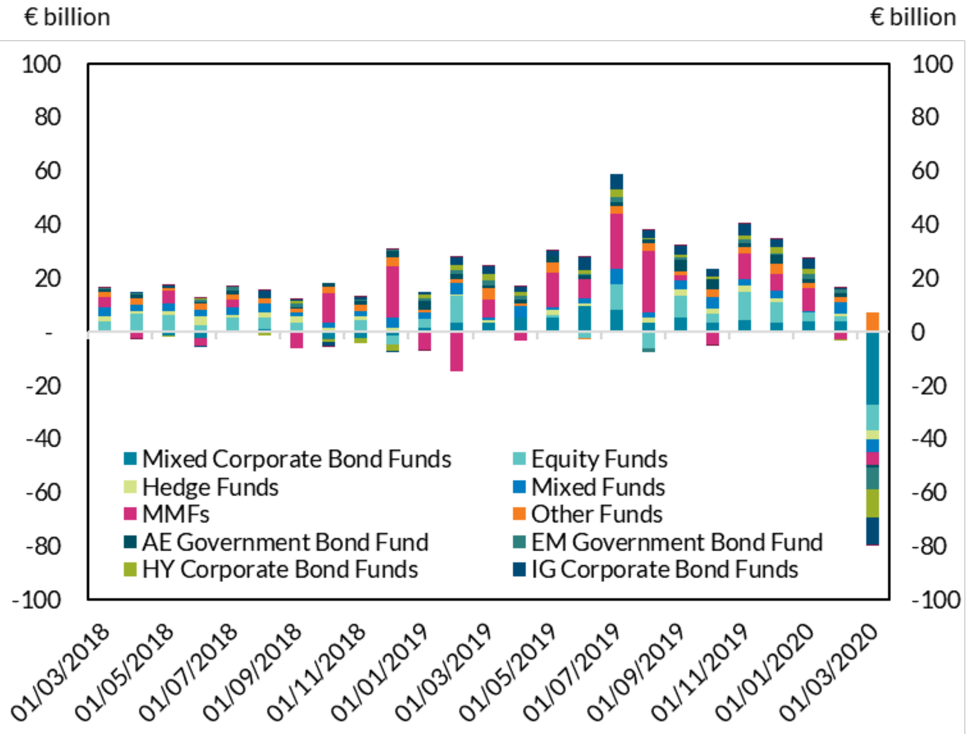
per cent of face value



Source: ESRB (2020a), based on data from iBoxx and ECB calculations.
Notes: Latest observations are for 3 May 2020.

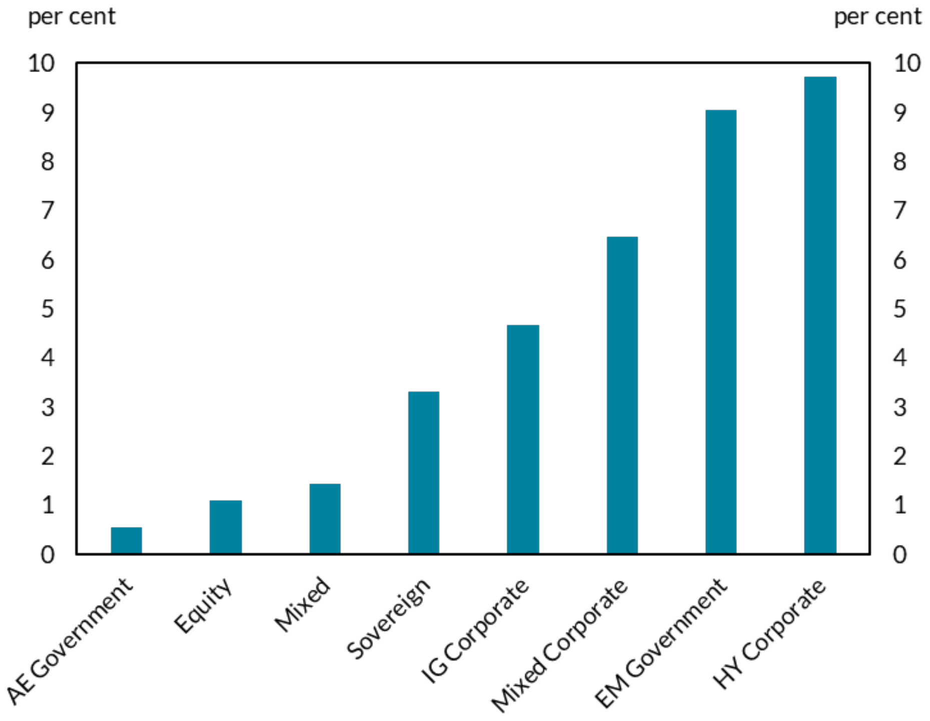
Consistent with global trends, Irish-domiciled funds also sharp redemptions, especially those invested in less liquid assets

Net flows in Irish-resident funds, € volumes, March 2018 – March 2020



Source: Central Bank of Ireland Financial Stability Review (FSR) June 2020.

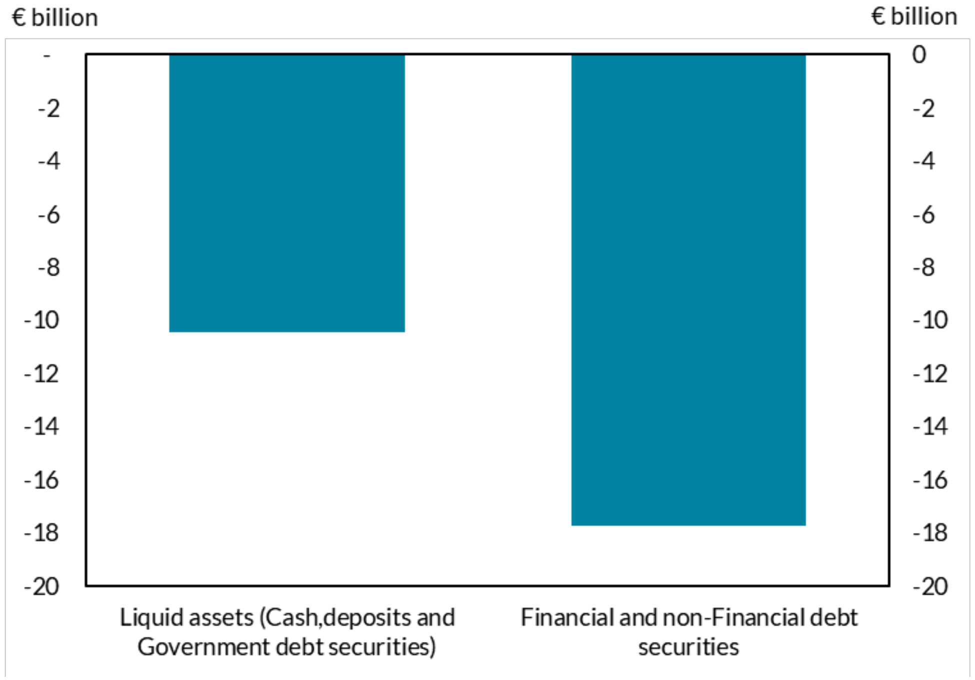
Outflows in Irish-resident investment funds as a % of previous period's AUM



Source: Central Bank of Ireland Financial Stability Review (FSR) June 2020.
Note: Data as at March 2020.

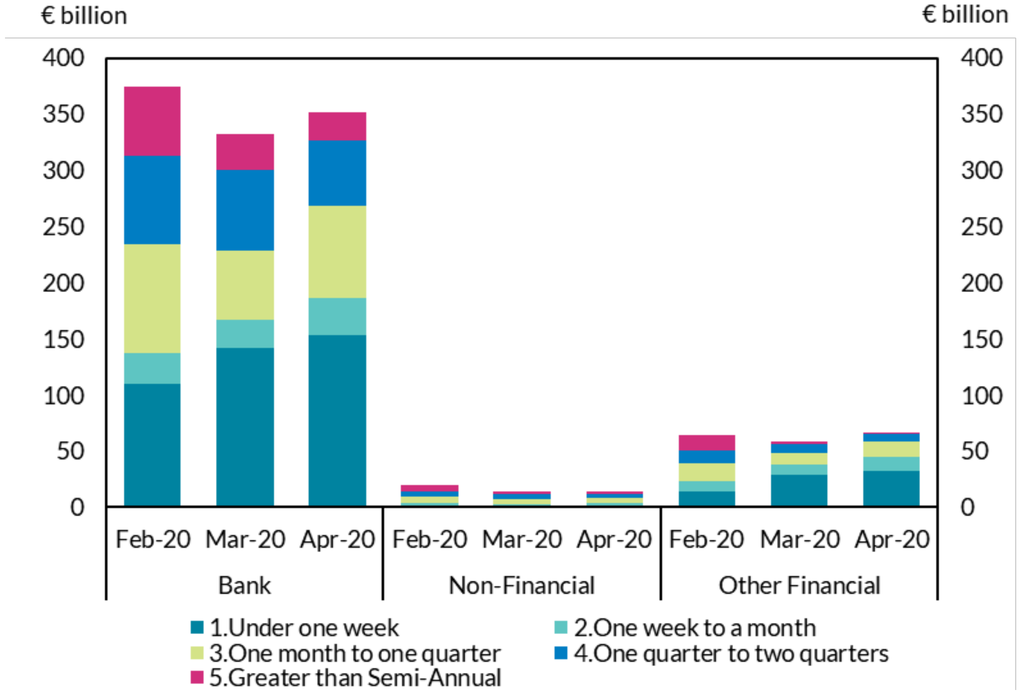
Corporate bond funds responded by selling less liquid assets and MMFs shortened the maturity of their assets

Irish-resident corporate bond fund asset sales, Q1 2020, € billions



Source: Central Bank of Ireland Financial Stability Review (FSR) June 2020.
Notes: Liquid assets comprise cash and deposits and government debt securities.

Irish-resident LVNAV MMFs assets by residual maturity, Feb-April 2020, € billions



Source: Central Bank of Ireland Financial Stability Review (FSR) June 2020.

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Why a macroprudential perspective?

"In trying to make themselves safer, banks, and other highly leveraged financial intermediaries, can behave in a way that collectively undermines the system. Selling an asset when the price of risk increases, is a prudent response from the perspective of an individual bank. But if many banks act in this way, the asset price will collapse, forcing institutions to take yet further steps to rectify the situation. It is, in part, the responses of the banks themselves to such pressures that leads to generalised declines in asset prices, and enhanced correlations and volatility in asset markets."

The Fundamental Principles of Financial Regulation, 2009

Developing the macroprudential policy framework

The macroprudential lens focuses on the **collective resilience** of the sector, not on **entity-by-entity resilience**. The channels that matter for financial stability stem from the collective behaviour of non-bank financial institutions and the impact of that behaviour on market functioning / the supply of finance to the economy.

Key open questions to operationalise the macroprudential framework for market-based finance:

- What are the most appropriate tools?
- Structural or time-varying policy interventions?
- Optimal approach to international co-ordination?
- Cost-benefit analysis of additional resilience in market-based finance?

There is no established playbook to guide us and there is **limited experience with using macroprudential tools in this part of the financial system**. However, we faced similar challenges when developing and operationalising tools for the banking sector that have since been overcome – and we are now seeing the benefits of those frameworks.