The Bank of England on NBFI and Leverage
November 7, 2022

Opening Remarks
Scott O'Malia, ISDA Chief Executive

Good morning, and welcome to this special event on non-bank financial intermediation (NBFI) and leverage. I'm sorry I can't be with you in person today, but I'd like to thank the Bank of England and the Alternative Investment Management Association for working with us to hold this very timely discussion.

It's timely, of course, because of recent events in the UK gilt market and the role of liability-driven (LDI) investment funds. At the end of September, a sharp rise in UK gilt yields following the government's so-called mini budget left those pension schemes pursuing LDI strategies facing huge margin calls on their derivatives positions. Many were forced to sell gilts to raise cash, leading to a self-reinforcing spiral of further margin calls and forced gilt sales – ultimately leading the Bank of England to announce temporary purchases in the gilt market to restore stability.

It's just the latest example of apparent vulnerabilities in NBFI having knock-on impacts on asset prices and liquidity in the broader market. Regulators globally have been looking at the impact of NBFI on financial stability following the March 2020 'dash for cash' and the collapse of Archegos Capital Management. Driving this work is concern that the growth of NBFI could amplify shocks, creating wider price volatility and liquidity stresses and disrupting the ability of markets to function.

The good news is that banks and the financial system as a whole are more resilient to stress, thanks to market reforms introduced after the 2008 financial crisis. For example, most standardized derivatives contracts are now cleared, while margin requirements are in place for non-cleared derivatives. Together, these two reforms have helped to mitigate counterparty credit risk. Higher capital requirements have also meant that banks are much more robust.

Implementation of these reforms has changed the nature of derivatives markets, with counterparty credit risk to some extent becoming less important than liquidity risk. We've experienced a series of liquidity crunches in key markets in recent years, including US Treasuries and gilts. The onset of the pandemic, higher inflation, fiscal policy proposals and the war in Ukraine have all been accompanied by extreme price volatility and knock-on impacts on securing adequate collateral.

This has prompted questions over whether balance sheet constraints on banks and dealers have contributed to these liquidity issues, as well as the impact of leverage on market volatility and the resilience of collateral operations and short-term funding markets. Regulators and market participants are increasingly asking what should be done to resolve this while maintaining increased systemic resilience.

In response to the recent market shocks, regulators have begun a program of work coordinated by the Financial Stability Board and the International Organization of Securities Commissions (IOSCO) to understand and address potential vulnerabilities.

For example, the Basel Committee, the Committee on Payments and Market Infrastructures and IOSCO published their latest report on margin practices in September, which looks at whether market participants were prepared for the large margin calls they faced in March 2020 and their ability to liquidate assets to meet margin calls under stressed market conditions.

According to that report, total initial margin requirements across central counterparties (CCPs) is estimated to have increased by around $300 billion in March 2020, while daily CCP variation margin (VM) calls increased from an average of roughly $25 billion in January 2020 to a peak of $140 billion the following month.

A similar dynamic occurred in commodity markets following volatility caused by the Russian invasion of Ukraine and again following the sell-off in UK gilts in September. To some extent, this should be expected – margin is intended to mitigate counterparty credit risk, so when markets are volatile, more margin will be required. But if firms are forced to sell assets to meet their margin calls, this can amplify shocks and create broader disruption across markets.

The report identifies six possible areas for further policy measures. These include enhancing the liquidity readiness of market participants and identifying appropriate liquidity measures in the NBFI sector. Other areas include work to streamline VM processes in cleared and non-cleared markets, and initiatives to explore model performance and consistent metrics and disclosures for procyclicality.

For ISDA's part, we think it's critical for financial stability that margin should be risk appropriate and not overly procyclical, without being capped. We also believe that markets should remain open to ensure critical payments and transactions can be fulfilled and firms are able to manage their exposures. Unexpected market closures or restrictions on trading can result in additional stress and uncertainty, affecting liquidity, risk management, transparency and stability.

We look forward to working with policymakers as they thrash out their approaches on this and as they look for solutions to improve NBFI liquidity readiness.

Another part of the NBFI ecosystem that has been in the spotlight is money market funds. Policymakers have highlighted structural vulnerabilities in this sector – namely, that certain types of money market funds are prone to sudden and disruptive redemptions and may struggle to sell assets at times of stress. The FSB published a set of policy proposals last year intended to enhance money market fund resilience, and the Bank of England and Financial Conduct Authority followed up with their own discussion paper in May this year.

While we recognize the need to look closely at this sector, we believe there are some important differences between non-public debt money market funds and public debt money market funds, with the latter experiencing much greater stability and even inflows during March 2020. We would urge regulators to bear that distinction in mind as they flesh out their proposals.

Likewise, NBFI encompasses a very broad ecosystem, including asset managers, pension schemes, hedge funds and others. We therefore hope regulators will continue to take a targeted, data-driven approach that recognizes the different constituents.

Given recent events, NBFI is clearly set to be a key focus for policymakers in the months ahead, and I know our keynote speaker will provide a really valuable perspective on this topic.

Sarah Breeden is executive director for financial stability strategy and risk at the Bank of England and a member of the Financial Policy Committee. Before taking up this position in August 2021, Sarah held a number of senior roles at the central bank, including executive director for UK deposit takers supervision and executive director for international banks supervision.

Sarah, thank you so much for joining us today.