Bank for International Settlements raises concerns over financial system

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As speculation on Wall Street and other stock markets roars ahead, researchers and analysts are continuing to delve into the events of March 2020 when global financial markets plummeted at the start of the pandemic and had to be rescued with a massive intervention by the US Federal Reserve.

So far, while some of the causes for the meltdown, which was centred in the $22 trillion US treasury market, have been identified, no solution has been advanced.

The latest institution to examine the crisis is the Bank for International Settlements (BIS), the umbrella organisation for central banks, which published a major analysis in its quarterly review issued earlier this week. It called for greater regulation of non-banking institutions, in particular bond funds, that have come to play an increasingly significant role in global financial markets over the past decade.

The bulk of the review is made up of highly technical details of the operations of the financial system but the conclusions of the analysis were clearly summed up in a foreword by Agustin Carstens, the general manager of the BIS.

He began by noting that non-bank financial intermediaries (NBFIs), such as bond funds and hedge funds, have "massively increased their footprint" since the global financial crisis of 2008. It is estimated that this virtually unregulated non-bank sector now accounts for nearly half of all financial assets.

Carstens claimed these institutions offered a broad range of investment and funding opportunities and represented a "healthy source of diversity" in financing.

At least that is the case when markets are operating normally, and things appear to be going well. It is a very different story when they are not.

"When things go wrong," he continued, "NBFIs can trigger or amplify market stress." This was the case at the start of the pandemic.

"In March 2020 and in previous episodes of market turmoil, the NBFI sector amplified stress through inherent structural vulnerabilities, notably liquidity mismatches and hidden leverage. With system-wide stability under threat, massive central bank support was necessary to restore the calm. Such repeated occurrences suggest that the status quo is unacceptable."

Carstens said fundamental adjustments were needed in the regulatory framework for NBFIs to make it fit for purpose.

In his summary of the March 2020 crisis, when the US treasury market, the basis of the global financial system froze—at one point there were no buyers for US government debt—Carstens pointed to one of the fundamental contradictions of all capitalist markets. This is, what may be rational behaviour for an individual participant can be irrational for the system as a whole.

When considering the system as a whole it was necessary to zoom out from the trees and consider the forest, he said.

"The overall system may be unstable even if individual institutions, considered on a standalone basis, may appear stable. In other word, actions that seem prudent from the viewpoint of individual institutions may destabilise the system."

This is what took place in March 2020. Faced with demands from investors for redemptions, NBFIs tried to obtain cash by selling assets under conditions where all sought "first mover advantage"—that is, moving out before others decided to do the same. The process was similar, Carstens noted, to a depositors' run on a bank.

Faced with actual or the threat of withdrawals, fund managers tend to hoard liquidity or liquidate assets.

"But what is prudent from their point of view has potentially negative repercussions for the system" and protecting the viability of individual funds "exacerbates the system-wide liquidity shortage." These mechanisms "were at play in March 2020."

The BIS review also noted that concerns for financial stability were rising in the world of cryptocurrencies or what it termed decentralised finance (DeFi).

Carstens noted that, in what he called the crypto ecosystem, problems had so far surfaced mainly in the form of frequent and sizeable price crashes: "Whether such fragilities are limited to this ecosystem or can spill over to the traditional one is still unclear."

However, the danger should not be underestimated because "as history confirms, anything that grows exponentially is unlikely to remains self-contained and thus merits the closest attention."

As was noted in the body of the review, if DeFi were to become widespread, "its vulnerabilities might undermine financial stability." And the disruptions could be severe "because of the high leverage, liquidity mismatches, built-in interconnectedness and the lack of shock absorbers such as banks."

The massive borrowing undertaken by NBFIs is also a source of destabilisation. The archetypal example is the use of leverage by hedge funds and asset managers for the purchase of securities with borrowed funds. This included the use of repos—very short-term, often overnight, procurements of cash—that are used to finance bets in financial markets.

"More recently," Carstens noted, "leverage has become high and pervasive in the DeFI world too. In such a context, price drops and increases in measured risks may make the lender call in a loan or charge a higher haircut, inducing forced selling."

Leverage was also pervasive in private markets which have gained ground in the recent period. Here risk-taking is procyclical. That is, investments increase when stock markets do well, and liquidity is ample, but increase instability when there is a downturn.

"Such risk-taking has contributed to the recent accumulation of debt in the system at large and may have broader financial stability implications, not least because banks fund private market operations and investors."

The central thrust of the policy prescriptions outlined in the review was a call for greater regulation of NBFIs.

But here Carstens was forced to acknowledge great obstacles, particularly in the case of the crypto world, or DeFi.

"Regulatory challenges may appear insurmountable in the case of DeFi, which is designed to avoid central oversight and rulemaking," Carstens wrote.

However, the problems confronting would-be regulators do not stop there because financial markets respond to increased controls by seeking new strategies to get round them. Carstens described regulatory efforts as a "continuing endeavour" and the task has "no clear beginning and no clear end."

"People inevitably want highest returns and higher liquidity. The financial system will try to deliver, in part by adapting to regulation [that is, seeking to get round it] as it evolves. All this inevitably raises system-wide risks," Carstens wrote.

Recent history provides a graphic example of this process. After the global financial crisis of 2008, which centred on the banks, new regulations were introduced in the US which somewhat constricted their activities in the treasury market.

But these actions only led to the growth in the activity of NBFIs which played a major role in the crisis of March 2020, and are now at the centre of the continuing threat of another meltdown.

The ongoing reports on the fragile state of the global financial system, including the latest review from the BIS, have major implications for the struggles of the working class.

Firstly, they reveal the essential driving force of the homicidal policies of all capitalist governments in relation to the COVID-19 pandemic. Their fear, as was revealed so clearly at the outset, is that any meaningful public health measures, based on science, will precipitate a collapse of the financial house of cards.

Secondly, they make clear that at any time an adverse event in the financial system, such as a wrongly placed bet by a hedge fund or some other financial institution, could trigger a chain reaction, bringing about a collapse of the entire system with incalculable economic consequences, including a depression and mass unemployment.

There are no reforms waiting in the wings to be implemented. The only viable perspective for the working class is the fight for political power as the first step in the reconstruction of the economy on socialist foundations, starting with the bringing of the entire financial system into public ownership under democratic control.