London
Business
School

Non-bank Financial Intermediaries

***

Crypto

Richard Portes

London Business School

Seventh ESRB Annual Conference, 16 November 2023

NBFIs – background

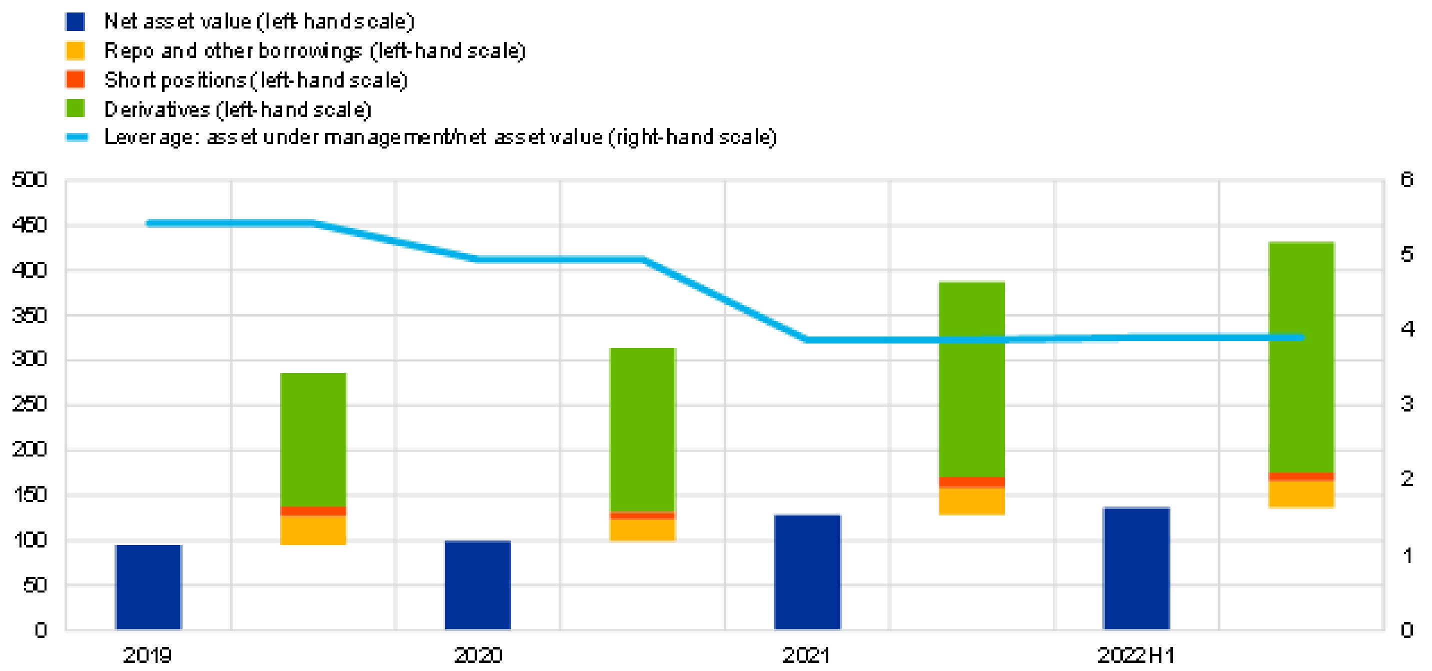
- NBFIs: investment funds, pension funds, insurers, other financial institutions, markets
- Current *risks*: rising interest rates, disorderly falls in asset prices, recession, liquidity strains in some markets
- *Vulnerabilities*: liquidity mismatch, excessive leverage, interconnectedness
- Conspicuous *dysfunctions*: runs on open-ended real estate funds and need to ‘gate’, Archegos, UK LDIs…
- *Official interventions*, sometimes central banks as ‘market makers of last resort’: in 2008, US AMLF (financing purchases of CP from MMFs), AIG bailout; 2016 BoE Corporate Bond Purchase Scheme, March 2020 (US and Europe), MMFs again, corporate bond markets again, interventions in UST and gilt markets
- Recent developments: Amended AIFMD, expansion of private credit

An example: derivatives and hedge fund leverage

Derivatives are the main source of hedge fund leverage.

EU hedge funds leverage decomposition and gross leverage

(left-hand scale – EUR billions; right-hand scale – multiple of NAV)



Sources: AIFMD.
Note: Data cover hedge fund AIFs reporting at least on a half yearly basis and managed by EU-domiciled AIFMs.

Source: *EU Non-bank Financial Intermediation Risk Monitor 2023*, at https://www.esrb.europa.eu/pub/pdf/reports/nbfi_monitor/esrb.nbfi202306~58b19c8627.en.pdf

NBFIs – some policy issues

- Alignment of redemption terms with liquidity of underlying assets, more anti-dilution tools (*e.g*. swing pricing), higher liquidity buffers wrt margin calls.
- Resilience/preparedness to margin calls in derivatives and collateral calls in repos
- Leverage and liquidity regulation of NBFIs?*
- NBFI access to central bank support in episodes of stress? If yes, should regulation be more extensive to limit moral hazard?
- Central bank intervention as 'market maker of last resort'? If unavoidable, need framework.
- Does private credit (NBFI direct lending) improve financial stability by moving lending from highly leveraged, duration-mismatched banks to less leveraged, duration-matched funds?

*See for example ESRB *Issues note on policy options to address risks in corporate debt and real estate funds from a financial stability perspective*, September 2023, at https://www.esrb.europa.eu/pub/pdf/reports/esrb.issuesnotepolicyoptionsrisksinvestmentfunds202309~cf3985b4e2.en.pdf

Crypto assets – background*

- Rapid growth 2017-21 – then crash from autumn 22. Market cap down 2/3, turnover down 2/3-3/4, Bitcoin down from $65K to as low as $16K (now $36K) .
- Failures, scams, hacks: Mt. Gox, 3AC, Voyager, Celsius, BlockFi, Genesis, FTX-Alameda, and 2 medium-size banks, Silvergate and Signature – and SVB role as banker to Circle
- Some 'stablecoins' not so stable, have broken their pegs (*e.g.* Tether, USDC)
- Key danger: interconnectedness with traditional financial system. Not yet but (for example) crypto asset ETFs may take off
- Lobbying
- Different regulatory approaches in different jurisdictions – little international cooperation
- EU now introducing wide-ranging Markets in Crypto Assets Regulation (MiCA), but not much related to financial stability

*See *Crypto-assets and decentralised finance*, ESRB, May 2023, at https://www.esrb.europa.eu/pub/pdf/reports/esrb.cryptoassetsanddecentralisedfinance202305~9792140acd.en.pdf

Risk scenarios

- **Collapse of algo stablecoins**
- **Information sensitivity $\Rightarrow$ run on reserve-backed stablecoin:** Liquidity vanishes, price volatility jumps; haircuts and margin calls surge triggering fire sales; transmission through *interconnections* between crypto and TradFi markets and institutions
- **TradFi institutions and infrastructures hold crypto/DeFi:** Price declines trigger loss of trust; decline in credit supply to healthy borrowers
- **Crypto/DeFi entities own TradFi institutions**
- **Native coins become prominent in TradFi payments:** Congestion or hacks undermine essential financial services

- What to do? Regulatory approaches – EU, US, let it implode, regulate like gambling

Crypto: personal reflections of a ‘mainstream’ economist

- *No convincing use case* for crypto – except crime, fraud, money laundering, regulatory arbitrage – maybe for blockchain (DLT), but what examples of efficiency savings?
- Blockchain financial transaction cost and duration should include KYC and AML (TradFi must satisfy)
- Crypto doesn’t have traditional attributes of money (nor is it an inflation hedge)
- Most crypto activity is in CeFi not DeFi – exchanges (CASPs) are not ‘decentralized’
- DeFi ‘smart contracts’ are *not* smart – no recourse (and can you really ‘trust code’?), no body of contract law
- Blockchain (DLT) vulnerable to hacks ($11 bn losses from 118 hacks on exchanges since 2012)
- Purchase and holding of native coins – in particular, Bitcoin – is gambling and should be regulated as such
- Otherwise, is formal regulation (*e.g.* MiCA) desirable? – it legitimizes crypto
- Danger of national competition to become crypto hubs and consequent regulatory arbitrage, crypto players ‘cherry-picking’ – UK Prime Minister is ‘thrilled’ that Andreessen Horowitz is establishing crypto hub in London (Ripple – sued by SEC – applauds new UK crypto regulation), France welcomed Binance (now having second thoughts), crypto may migrate to HK and Dubai…Hence *need for close international cooperation*.