BRIEFING

Public hearing with the Chair of the European Systemic Risk Board

ECON 23 September 2019

This note is prepared in view of a regular public hearing with the Chair of the European Systemic Risk Board (ESRB), Mario Draghi, which will take place on 23 September 2019. The briefing provides an overview of recent actions by the ESRB, such as systemic risks identified, input for recent stress testing exercise, and assessment of compliance with public ESRB recommendations.

Overview

The ESRB is responsible for *'the macroprudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability [...]'* (Article 3(1) of the ESRB Regulation) and coordination of EU policies for financial stability. For a more detailed description of the ESRB, see EGOV briefing "ESRB – main features, mandate and accountability".

As part of the ESRB accountability to the European Parliament (EP) framework, the Chair of ESRB is invited at least annually to a hearing at the EP. The last hearing took place on the 28th of January, 2019, where the Chair of the ESRB, Mario Draghi briefly overviewed recent national macroprudential measures and work done at the ESRB to address financial stability considerations around non-performing loans (NPLs), namely the ESRB report on macroprudential approaches to NPLs.

In his opening remarks in January, Mr Draghi also raised several issues to be addressed in the near future, such as:

- heterogeneous macroprudential policy toolkit across the EU (Mr Draghi mentioned that policy toolkit is well developed and operationalised, however, it is not available in all the Member States, restricting their competent authorities' ability to act in preventing systemic risk from build-up);
- lack of borrower based measures outside household sector;
- lack of macroprudential policy framework beyond banking (in 2016 the ESRB published a Strategy paper to address this issue, however, this policy field remains underdeveloped and Mr Draghi has pointed out that *"no significant progress has so far been made on incorporating macroprudential tools for non-banks into the EU legal framework"*);
- need to close the existing data gaps and more high-quality, detailed and granular data for policy decisions;
- called Member states to address remaining legal and judicial framework inefficiencies to better address and resolve the NPL issue.

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Systemic risks identified by the ESRB

In the last Annual report, published in late-July 2019, the ESRB has identified four main systemic risks to the EU financial stability which were also echoed during the General Board meetings in March and June, 2019. The key financial stability risks listed by the ESRB are identified over a three-year horizon.

Below are the main findings on systemic risks by the ESRB. Other potential risks that are not addressed in the ESRB Annual Report include Libra (see Box 1) and the complexity of financial regulation as emphasised by ESRB Advisory Scientific Committee (ASC) (see Box 2).

1 Repricing of risk premia in global financial markets (marked as high risk)

Vulnerabilities: mispricing of risks and excessive risk-taking amid low funding costs and search for yield.

Potential triggers: escalation of uncertainties related to the international framework of economic relations and corresponding adjustments to the economic outlook, shocks to risk premia, e.g. due to (geo)political events globally or within Europe (e.g. hard Brexit, policy uncertainties in Italy), materialisation of risks in key EMEs.

2 Persistent weakness in balance sheets of EU banks, insurers and pension funds (marked as medium risk)

Vulnerabilities (banks): challenges to sustainable sources of profits in the low interest rate environment, with structural changes like digitalisation and fintech challenging banks' business models, still significant asset quality issues as well as low cost efficiency and excess capacity in certain countries.

Vulnerabilities (life insurers and pension funds): low-yield environment increasing the liabilities of life insurers and pension funds and creating return challenges for long-term investments, particularly affecting guaranteed return life insurers and defined-benefit pension schemes.

Potential triggers: significant prolonged profitability pressures (banks), revaluation of liabilities at low interest rates (life insurers), weak returns on financial investments, systemic cyber attacks.

3 Debt sustainability challenges in EU sovereign, corporate and household sectors (marked as medium risk)

Vulnerabilities: high indebtedness in public and private sectors, with a limited capacity to absorb shocks.

Potential triggers: shocks to the medium-term growth outlook (e.g. due to an escalation of uncertainties related to the international framework of economic relations or slow implementation of structural reforms), materialisation of policy risks potentially having an impact on the fiscal space, re-pricing in financial markets.

4 Vulnerabilities in the investment fund sector and risks from shadow banking activities (marked as risk)

Vulnerabilities: further increasing size and complexity of the investment fund and other financial institution sectors, liquidity and leverage in certain types of investment funds, lack of transparency and comprehensive risk monitoring, interconnectedness and potential for contagion to other parts of the financial system, e.g. via cross-border linkages or step-in risk.

Potential triggers: re-pricing in global financial markets with a potential for fire sales and liquidity squeezes.

It must be noted that while the first two risk trends described above (i.e., repricing of risk premia and persistent weakness in EU financial sector balance sheets) may potentially be impacted by the monetary policy conducted by the ECB, the ESRB does not assess the conduct of monetary policy per se (see Article 16(2) of the ESRB Regulation).

According to Article 3(1) of the ESRB Regulation, the ESRB is responsible for assessing, contribute to the prevention and mitigation of risks "*that arise from developments within the financial system and taking into account* ***macroeconomic developments***" (our emphasis). This dilemma has been highlighted in a study commissioned by the EP[1] which contains a recommendation to clarify ESRB mandate. The recommendation suggests clarifying the reference to "*macroeconomic developments*" (*"Recommendation E: Clarify the reference to macroeconomic developments in the ESRB's mandate"*). The authors of the report consider that having the ESRB involved in discussing the impacts and effects of monetary policy would not impinge on ECB independent decision making on monetary policy.

Some recent ESRB actions and policy answers

The ESRB does not have binding instruments nor powers to address systemic risks[2], but may address recommendations, warnings and opinions to national authorities or to the European Supervisory Authorities. There has been no new public ESRB recommendations or warnings published in 2019 (see last part of this briefing "Assessment of compliance with public ESRB recommendations"). The use of non-public warnings and recommendations are not available in the public. The ESRB has been using its "soft powers" to raise awareness about potential triggers, vulnerabilities and pass through mechanisms.

It has also undertook a number of studies (some of which are identified below), the full list of ESRB publications can be found in their website:

- Handbook on operationalizing macroprudential policy in the banking sector;
- Addendum: Macroprudential leverage ratios;
- ESRB report on macroprudential approaches to NPLs;
- ESRB report on CCP inoperability arrangements;
- ESRB report on Macroprudential policy beyond banking;
- ESRB working paper on use of credit default swaps by UCITS funds,
- ESRB working paper on the effect of possible EU diversification requirements on the risk of banks' sovereign bond portfolios,
- ESRB working paper on effectiveness of policy and regulation in European sovereign credit risk markets,
- ASC report on ETF contribution to systemic risk.

[1] "*The apparent lack of discussion of risks arising from fiscal policy, such as the tax treatment of debt and equity, and the reported difficulty that some* ***General Board Members experienced in arguing for prioritisation of financial stability risks arising from the low interest rate environment,*** *attest to the potential benefits of a textual clarification of the ESRB's mandate.* ***In particular, such a modification could make clear that commenting on the consequences for the financial system of monetary policy in no way prejudices the independence of monetary policy decision making*** *(see Recommendation E)*." (our emphasis).

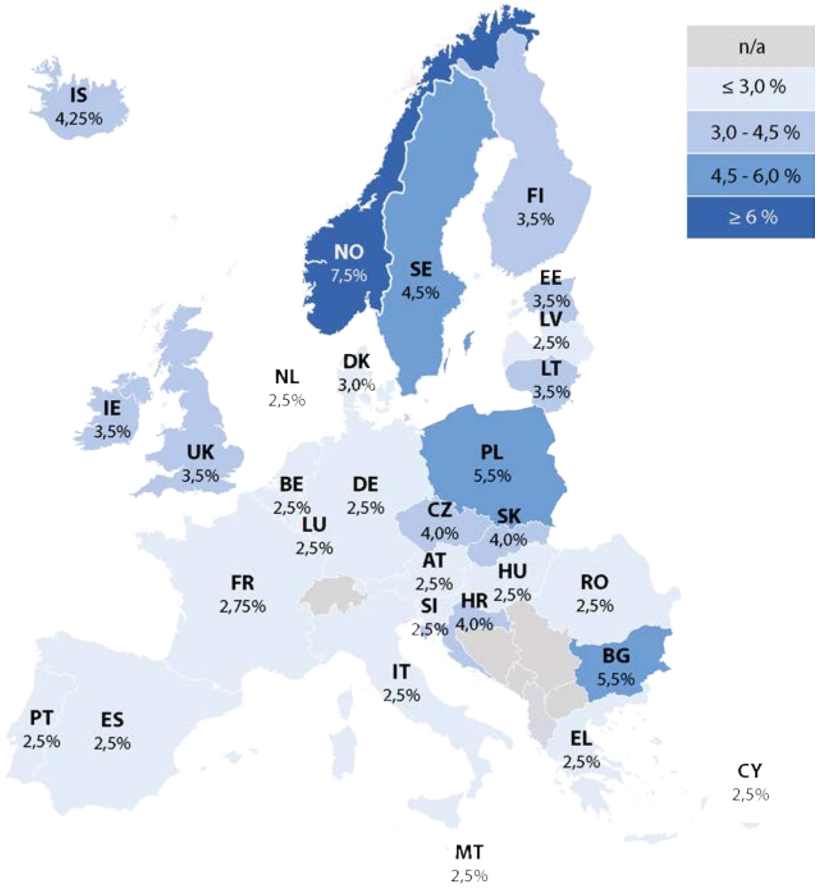
[2] This is linked to the legal nature of the ESRB. Contrary to the other bodies within the European System of Financial Supervision, the ESRB does not have legal personality. In a study commissioned by the EP, this has not been considered a deterrent for ESRB action: "*However, the evidence gathered for this study suggests that the lack of formal powers is unlikely to have acted as a significant impediment to the ESRB's contribution to risk prevention or mitigation*".

While the ESRB, as an institution responsible for the macroprudential oversight does encourage Member States to implement appropriate macroprudential measures in order to address financial stability, national macroprudential policy responses remains rather heterogeneous across EU Member States.

Figure 1 features how macroprudential capital buffers are implemented across the Union. While financial stability risks in Member States can only partially be addressed by macroprudential capital buffers, the level of minimal combined capital buffer add on seem on average less significant in euro area Member States than in other Member States (for more information, see Annex 1).

In the Banking Union, macroprudential policy is a shared responsibility between national macroprudential authorities which are responsible for setting the appropriate buffer and the ECB, which may, in accordance with Article 5 of the SRB Regulation "top-up" national measures. In other words, the ECB may decide to apply higher requirements throughout the euro area, where deemed appropriate.

Figure 1. Minimal combined macroprudential capital buffer add on (combines CCoB, CCyB, SyRB when applied to all banks)



Source: EGOV based on ECB.

Box 1

Other risks: G7 and Eurogroup calls to address the various risks and their potential macroeconomic and financial stability implications of the stablecoins and the Libra project more specifically

G7 Ministers and Governors in their meeting in Chantilly, 17-18 July, 2019 and Eurogroup Ministers in their meeting in Helsinki, 13 September, 2019 have discussed and acknowledged that while innovation in the financial sector can bring substantial benefits, it can also entail risks. On both foras they agreed that stablecoins and other various new products currently being developed (including projects such as Libra that could have global and systemic footprint) raise serious regulatory and systemic concerns, as well as wider policy issues, which both need to be addressed before such projects can be implemented.

Ministers and Governors had agreed that stablecoin initiatives and their operators would need to meet the highest standards of financial regulation, especially with regards to AML, in order to ensure they do not affect the stability of the financial system, or consumer protection. In order to resolve these regulatory concerns, possible existing regulatory gaps would need to be addressed.

Also, they have agreed that crypto assets (also known as cryptocurrencies) may affect monetary sovereignty and the functioning of the international monetary system. In order to address these systemic concerns, Ministers and Governors stressed the need for cross-border payment systems to be significantly improved and less costly for consumers.

Box 2

Other risks: outlined in the ASC report "Regulatory complexity and the quest for robust regulation"

The ASC has recently published a report on regulatory impact on systemic risk. They have argued that both excessively complex regulations, and overly simple financial regulations are contributing to growth of systemic risk through different transmission channels and incentives. The report concludes that a transparent cost-benefit analysis, greater evidence-based design of financial regulation, and evaluations of the effectiveness of regulations are desirable actions by regulators in order to improve financial regulation and to avoid an increase in systemic risk due to excessive regulatory complexity.

The report proposes seven principles to adopt in the quest for robustness in financial regulations:

- *Adaptability*
- *Diversity*
- *Proportionality*
- *Resolvability*
- *Systemic perspective*
- *Information availability*
- *Non-regulatory discipline*

Several recently introduced regulatory developments have been analysed. For example, the introduction of a Single Resolution Mechanism, which was designed to provide an adequate toolkit to allow orderly resolution of banks without compromising financial stability or resorting to public funds, was a very welcome development. However, the effort to fit a new institution into the pre-existing architecture, resulted in convoluted procedures (decision to determine the needed resolution action involves a wide array of EU institutions – the ECB, National Resolution Authorities, the European Commission, the Single Resolution Board – that must act under tight deadlines).

For a more detailed list of quantitative and qualitative indicators of systemic risk in the EU financial system, please check the latest Risk Dashboard published on the ESRB website and updated quarterly.

ESRB as input provider for EU stress testing exercise

Every two years, the ESRB in close collaboration with the European Central Bank (ECB), the European Banking Authority (EBA), the European Insurance and Occupational Pension Authority (EIOPA) and the European Securities and Market Authority (ESMA) assesses the resilience of EU financial system participants. In accordance with its mandate and in line with the risks highlighted in their annual report, the ESRB develops and calibrates an adverse scenario for the stress tests for banking sector (last stress test performed in 2018: scenario and results), insurance (last stress test performed in 2018: scenario and results), central counterparties (currently ongoing stress exercise in 2019: scenario and results expected in Q2 2020), pension and money market funds (currently ongoing stress exercise in 2019: scenario and results expected in end of 2019).

To calibrate financial shocks for adverse scenarios, the ESRB uses Financial Shock Simulator, a state-of-the-art tool developed by the ECB. This tool is regularly employed not only for stress test scenario calibrations, but also for internal and external policy analysis, such as impact assessments in the Financial Stability Review. Once calibrated the adverse scenarios are approved by the ESRB General Board and transmitted to the respective European Authorities for execution.

Recently the European Court of Auditors has assessed the quality of the stress tests performed by EBA, for a summary of the findings please see Box 3. In the same vein, the methodology and the input parameters used have already been critically analysed in previous briefing papers commissioned by EGOV. In one of the papers published in June 2018, Haselmann and Wahrenburg for example identified several inconsistencies when comparing the calibration of the ESRB adverse scenario with the EBA/ECB market risk scenario (see "How demanding and consistent is the 2018 stress test design in comparison to previous exercises?"). They also found that, given the extremely heterogeneous macroeconomic scenario among EU-countries used for the 2018 EU-wide stress test, it could rather be deemed to be a "country-by-country" stress test.

Box 3

European Court of Auditors concluded that "simulated shocks were actually milder than those experienced during the 2008 financial crisis and the adverse scenario used did not appropriately reflect all relevant systemic risks to the EU financial system"

The European Court of Auditors (ECA) has assessed whether the EU wide stress test performed was fit for purpose, whether the EBA had sufficient assurance about the robustness of the figures calculated by the individual banks, and whether the publication of the results allowed stakeholders to conclude whether the system was resilient.

In their special report on "EU wide stress tests for banks" the ECA concluded that:

- "an EU-wide perspective was insufficiently taken into account in the design and implementation of the stress test.
- the EBA lacked control over important stages of the process and thus:
  - important systemic risks were subject to a low level of stress, or none at all;
  - the shock was not triggered by events from within the EU financial system but by an economic downturn;
  - the intensity of the economic shocks varied significantly from country to country, with the shock often being less severe where the economy was weaker and the financial system was more vulnerable. A minimum level of severity to generate stress was not ensured.
- although the regulation entrusted the EBA with ensuring the reliability and comparability of methods, practices and results, the EBA did not exercise authority beyond initiating, providing methodology for and broadly coordinating the stress-test activities. It decided to fully rely on the CAs for verifying the way banks implement the methodology and estimate stress impacts. The EBA did not challenge the CAs' quality control using the powers conferred on it by the regulation
- the EBA's publications showed an unprecedented level of transparency as a large amount of bank data was made accessible. However, in its reports the most critical information was missing, namely the capital requirements for each bank and how many banks would have breached them under stress."

Assessment of compliance with public ESRB recommendations

The ESRB recommendations are not legally binding, but they are subject to a "comply or explain" rule (this means that the addressees of recommendation have an obligation to report to the ESRB they have taken to comply with a recommendation or provide adequate justification in the case of inaction). These warnings and recommendations **can be made public** following a decision of the General Board **on a case-by-case basis**.

During 2019, there were no new public warnings or recommendations issued, however, there was one amendment of a recommendation (Amendment of Recommendation ESRB/2016/14 on closing real estate data gaps) and one decision of the postponement of certain reports (Decision ESRB/2019/15 on the postponement of certain reports on actions and measures taken pursuant to Recommendation ESRB/2014/1 and Recommendation ESRB/2015/2).

Since early 2018, the ESRB has carried out three recommendation compliance assessments.

- Assessment of compliance with Recommendation ESRB/2012/1 on money market funds.

This recommendation aims to reduce the systemic risks arising from money market funds (MMS) and was addressed to the European Commission. The recommendation aimed to ensure implementation of fluctuating net asset value model, the introduction of stricter liquidity requirements, the public disclosure of specific information by MMS and the adoption of enhanced obligations for reporting to supervisory authorities.

The assessment team found European Commission's proposal for regulation to be **largely compliant** with the recommendation.

- Assessment of compliance with Recommendation ESRB/2014/1 on guidance for setting countercyclical buffer rates.

This ESRB recommendation provides guidance on setting countercyclical buffer (CCyB) rates, with the aim of establishing a common approach across the EU and was addressed to the designated macroprudential policy authorities. Specifically, it lists a set of principles which should be adhered to when assessing and setting the CCyB rates. The role of the ESRB in providing such guidance is set out in Article 135 of the CRD IV.

The assessment team found that addresses have **accomplished** a timely and comprehensive operationalisation of the CCyB, despite the limited number of decisions to set or change the CCyB rates.

- Assessment of compliance with Recommendation ESRB/2015/2 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures.

This ESRB recommendation aims to promote a coordinated policy approach across borders within the EU, prevent financial service providers from circumventing national macroprudential measures and reduce regulatory arbitrage. The recommendation focusses on the assessment of cross-border effects of national macroprudential policy measures and sets out the procedures to be followed when requesting reciprocation and submitting reciprocation notification.

The assessment is **still ongoing** and is expected to be completed in the course of 2019.

Annex 1. National macroprudential policy measures and key economic indicators

Country	CCoB[1]	CCyB[2]	The higher of			Combined buffer requirement[4]	Annual real GDP growth rate, 2018	Private sector debt, % of GDP	Housing price index, 2018[5]	Domestic credit-to-GDP gap ratio Q1 2019
			G-SII buffer	O-SII buffer	SyRB[3]					
	CRD 129	CRD 130	CRD 131	CRD 131	CRD 133					
Austria	2,5%	0%		9 banks: 0.5%-2%	13 banks: 0.5%-2%	2.5%-4.5%	2,7%	122,5%**	2,6%	-7.2%
Belgium	2,5%	0%-0,5%*		8 banks: 0.75%-1.5%		2.5%-4%	1,4%	184,8%	1,1%	-22.1%
Bulgaria	2,5%	0%-1%*		10 banks: 0.25-0.75%	All banks: 3%	5.5%-6.25%	3,1%	101,1%**	3,9%	-20.6%
Croatia	2,5%	0%		7 banks: 0.2-2%	All banks: 1.5%-3%	4%-5.5%	2,6%	98,2%**	4,8%	n.a.
Cyprus	2,5%	0%		5 banks: 0.125%-0.5%		2.5%-3%	3,9%	315,1%**	0,6%	-67.4%
Czech Republic	2,5%	1,5%-2%*		7 banks: n/a	5 banks: 1%-3%	4%-7%	3,0%	70,7%	6,1%	0.8%
Denmark	2,5%	0,5%-1,5%*		7 banks: n/a	7 banks: 0.5%-3%	3%-6%	1,5%	199,4%	3,5%	-31.9%
Estonia	2.5%	0%		4 banks: 1%-2%	All banks: 1%	3.5%-5.5%	3,9%	106,4%**	2,6%	-13.0%
Finland	2.5%	0%		3 banks: 0.5%-2%	All banks: 1%-3%	3.5%-5.5%	1,7%	142,0%	-0,1%	-9.9%
France	2.5%	0,25%-0,5%*	3 banks: 1%-1.5%	6 banks: 0.25%-1.5%		2.75%-4.25%	1,7%	148,0%**	1,5%	2.2%
Germany	2,5%	0%-0,25%*	1 bank: 2%	13 banks: 0.16%-2%		2.5%-4.5%	1,5%	101,1%**	5,2%	1.8%
Greece	2,5%	0%		4 banks: 0.25%		2.5%-2.75%	1,9%	110,3%	1,3%	-31.7%
Hungary	2,5%	0%		8 banks: 0.375%-1.5%		2.5%-4%	4,9%	70,8%	6,2%	-30.5%
Ireland	2,5%	1%		6 banks: 0%-0.5%		3.5%-4%	8,2%	241,2%**	8,3%	-77.8%
Iceland	2,5%	1,75%-2%*		3 banks: 2%	8 Banks: 2%-3%	4.25%-9.25%	4,8%			n.a.
Italy	2,5%	0%	1 bank: 1%	3 banks: 0%-0.5%		2.5%-3.5%	0,9%	107,6%	-1,7%	-14.9%
Latvia	2.5%	0%		5 banks: 1.25%-2%		2.5%-4.5%	4,8%	83,5%**	6,6%	-22.9%
Liechtenstein	2,5%	0%		3 banks: n/a	3 banks: 2.5%	2.5% - 5%				n.a.
Lithuania	2,5%	1%		4 banks: 0.5%-2%		3.5%-5.5%	3,5%	56,1%**	4,8%	-1.4%
Luxembourg	2.5%	0%-0,25*		8 banks: 0.5%-1%		2.5%-3.5%	2,6%	316,4%**	5,2%	-76.1%
Malta	2,5%	0%		3 banks: 0.5%-2%		2.5%-4.5%	6,8%	118,5%**	5,0%	-23.4%
Netherlands	2,5%	0%	1 bank: 1%	5 banks: 1%-2%	3 banks: 3%	2.5%-5.5%	2,6%	241,6%	7,4%	-27.8%
Norway	2,5%	2%-2,5*		2 financial corporations: n/a	All banks: 3%-5%	7.5%-9.5%	1,3%			n.a.
Poland	2,5%	0%		11 banks: 0%-1%	All banks: 3%	5.5%-6.5%	5,1%	76,1%	4,8%	-10.6%

Country	CCoB[1]	CCyB[2]	The higher of			Combined buffer requirement[4]	Annual real GDP growth rate, 2018	Private sector debt, % of GDP	Housing price index, 2018[5]	Domestic credit-to-GDP gap ratio Q1 2019
			G-SII buffer	O-SII buffer	SyRB[3]					
	CRD 129	CRD 130	CRD 131	CRD 131	CRD 133					
Portugal	2,5%	0%		6 banks: 0.125%-0.5%		2.5%-3%	2,1%	156,0%	9,0%	-50.4%
Romania	2,5%	0%		9 banks: 1%-2%	22 banks: 1%-2%	2.5%-4.5%	4,1%	48,1%	1,8%	-2.1%
Slovakia	2,5%	1,5%-2%*		5 banks: 0.5%-1%	3 banks: 1%	3.75%-5.75%	4,1%	96,1%**	5,0%	-5.3%
Slovenia	2.5%	0%		6 banks: 0.25%-1%		2.5%-3.5%	4,1%	71,8%	7,2%	-24.6%
Spain	2,5%	0%	1 bank: 1%	5 banks: 0.25%-1%		2.5%-3.5%	2,6%	133,1%	5,1%	-47.3%
Sweden	2,5%	2%-2,5%*		4 banks: 0%-2%	3 banks: 3%	4.5%-7.5%	2,4%	197,4%	-3,3%	-1.7%
United Kingdom	2,5%	1%	4 banks: 1%-2%	15 banks: n/a		3.5%-5%	1,4%	170,9%	1,0%	-20.0%

Footnotes
* Marks already announced CCyB increases that will come into force throughout the course of 2020.
** Marks data points for 2017, where 2018 data is not available

Notes to the table:
The table includes information on supervised banks (e.g. excluding O-SII buffer requirements for investment firms in Cyprus) and includes at the individual bank-level all banks subject to individual structural buffers (G-SII, O-SII, SyRB).
1) The introduction and phasing-in of the CCoB represents the implementation of Article 129 and 160 CRD IV in national legislation with possible shorter transitional periods leading to different requirements across countries. In addition, possible exemptions for small and medium-sized investment firms by some national authorities may apply. The ECB is not notified of the CCoB, but it is included in the table to calculate the combined buffer requirements.
2) The effective bank-specific CCyB rate can be higher or lower as it is affected by the CCyB rate of the country where exposures are located, see Art. 140 CRD IV. For Italy, Luxembourg, Malta and Slovakia small and medium-sized investment firms are exempted from the CCyB.
3) In Estonia and Slovakia the SyRB is applied only on domestic exposures, the buffer is cumulated to the higher of the O-SII and G-SII buffers, in line with Art. 133(5) CRD IV. In Estonia all banks - not only systemically important ones - are subject to the SyRB buffer.
4) The combined buffer requirement is calculated according to Art. 131 CRD IV but excludes mandatory or voluntary reciprocity of foreign macroprudential measures according to recommendation ESRB/2015/2. It consists of CET1 capital and comes in addition to a minimum requirement of 8% total capital (4.5% CET1 + 1.5% AT1 + 2% T2). Pillar 2 measures are not included. The minimum combined buffer requirement at country level corresponds to a bank not subject to any individual bank-level structural buffer (G-SII, O-SII, SyRB).
5) The deflated house price index (or real house price index) is the ratio between the house price index (HPI) and the national accounts deflator for private final consumption expenditure (households and non-profit institutions serving households (NPISHs)). This indicator therefore measures inflation in the house market relative to inflation in the final consumption expenditure of households and NPISHs.

Sources: ECB, Eurostat.

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