

Public hearing with Christine Lagarde, Chair of the European Systemic Risk Board

ECON on 19 November 2020

This note is prepared in view of a public hearing with the Chair of the European Systemic Risk Board (ESRB), Christine Lagarde, which will take place in ECON on 19 November 2020. This will be the second hearing with Ms Lagarde in her capacity as a Chair of the ESRB. The aim of the meeting is to discuss recent developments in the macroprudential policy field and the impact of the corona crisis.



The briefing provides a (i) summary of the ESRB Annual Report, (ii) addresses the ESRB and national macroprudential authorities' response to the COVID pandemic outbreak, (iii) including recent ESRB Recommendations to the European Commission and national authorities; (iv) latest ESRB systemic risk assessment and (v) other macroprudential policy concerns.

1. ESRB Annual report 2019

The [2019 ESRB Annual Report](#) exceptionally includes an assessment of risks up to 25 June 2020 in order to reflect the systemic risks following the start of the pandemic (see also section 4 of the briefing). The Annual Report gives an overview of the recommendations and warnings issued during the review period (see Annex of this briefing for a full list of recommendations and warnings). Prior to the start of the COVID-19 crisis, the ESRB issued five warnings (to the Czech Republic, Germany, France, Iceland, Norway) and six recommendations (to Belgium, Denmark, Luxembourg, Netherlands, Finland, Sweden) on medium-term residential real estate sector vulnerabilities, and amended an earlier recommendation on closing real estate data gaps.

The Annual Report further highlights the role played by the ESRB in the now-postponed 2020 European Banking Authority (EBA) EU-wide stress test, but states that it “*intends to design a new scenario to reflect the risk landscape at the time of the re-launch of the exercise*” (see also section 5 below).

The work done by the ESRB to enhance the macroprudential toolkit outside the banking sector is also discussed in the Annual Report (see Box below).

The Annual Report further details the changes to the [ESRB Regulation](#) which took effect in 2019, including a wider definition of systemic risk and changes to the ESRB's governance structure (see previous [EGOV briefing](#) for a discussion of the amended Regulation).



2. Macroprudential policy response to COVID-19 outbreak

As [recognised](#) by the ESRB General Board, the “*main source of systemic risk in the EU originates from the negative impact of the pandemic on economic activity and the risk of widespread defaults in the private sector and their feedback effects on the EU financial system*”. In her previous hearing before ECON on 8 June, ESRB Chair Christine Lagarde [elaborated](#) upon these risks, and the relevant role played by the financial system in this crisis: “*while the financial sector is not immune to the shock, it needs to be able to help absorb it, rather than amplify it*”. The ESRB has thus identified [five key priority areas](#) for action:

- **Implications for the financial system of guarantee schemes and other fiscal measures to protect the real economy:** The ESRB considers that dialogue between macroprudential and fiscal authorities is crucial to assessing the financial stability impact of crisis response measures. The ESRB has thus [strongly encouraged](#) cooperation and information exchange between national authorities, and issued a [Recommendation](#) on monitoring the financial stability implications of the crisis response (see also section 5 below).
- **Market illiquidity and implications for asset managers and insurers:** The ESRB has issued both a [Recommendation](#) on liquidity risks in investment funds and a [Public Statement](#) on the use of liquidity management tools by investment funds. On 12 November, the European Securities Markets Authority (ESMA) responded with a [report](#) on the preparedness of investment funds to potential adverse shocks.
- **Impact of large scale downgrades of corporate bonds on markets and entities across the financial system:** The ESRB analysed the market impact linked to large-scale corporate bond downgrades as well as the potential transmission of risk to financial institutions, as can be found in the following [issues note](#) and [technical note](#). The findings are summarised in this [letter](#) to the European Commission and ESMA.
- **System-wide restraints on dividend payments, share buybacks and other pay-outs:** In response to such measures by national and European authorities, the ESRB issued a [Recommendation](#) on the issues, in addition to a [Report](#) discussing complementary macroprudential actions.
- **Liquidity risks arising from margin calls:** In addition to issuing a [Recommendation](#) and [Report](#) on this topic, ESRB members have been exchanging views on the possible adverse liquidity impact on bank and non-bank entities.

A list of all recent Recommendations issued by the ESRB can be found in the Annex.

These actions taken by the ESRB complements the range of measures taken by EU- and euro area-level institutions in response to the crisis (see [here](#) for an overview of all such relevant policy responses). Moreover, at the national level, macroprudential authorities in a number of Member States have taken action to address the impact of COVID-19 on the financial sector:

- Certain Member States fully or partially reduced the countercyclical capital buffer (CCyB) (Czech Republic, France, Ireland, Lithuania, Sweden, Slovakia) and/or revoked previously announced CCyB activations (Belgium, Bulgaria, Germany, Denmark). As it stands, Slovakia (1%) and Luxembourg (0.25%, set to increase to 0.5% on 1 January 2021) are now the only euro area Member States maintaining a positive CCyB rate.
- A smaller number of Member States have also reduced the systemic risk buffer (SyRB) (Estonia, Finland, Hungary,¹ Netherlands, Poland)² and/or the other systemically important institutions buffer (O-SII) (Finland, Hungary, Netherlands). While the SyRB continues to apply in many non-euro area countries³, only Austria, the Netherlands and Slovakia currently have a positive SyRB in the euro area.
- A number of authorities postponed the phase in or introduction of previously announced measures (Cyprus, Greece, Lithuania, Portugal, Netherlands).

¹ Hungary has suspended the general requirements of the SyRB and postponed any revision of the rate in 2020.

² With Ireland delaying its introduction of the SyRB.

³ Iceland, Bulgaria, Croatia, Denmark, Lichtenstein, Norway, Romania, Sweden.

A full overview of macroprudential measures taken by national authorities in the euro area can be found [here](#), and for all EU countries [here](#).

Some recently published research papers have questioned the effectiveness of macroprudential tools in this crisis. In the October 2020 ECB Macroprudential Bulletin, [Pariès, Kok and Rottner](#) (2020) estimate whether higher CCyB accumulation would have a positive impact on economic resilience when banks face a shock akin to that of the current crisis. Indeed, they find that the “*limited build-up of releasable capital before the crisis has, however, somewhat hampered the ability of macroprudential authorities to act countercyclically*”, with negative implications for macro-financial stabilisation. This echoes the findings of [Abad and Repullo](#) (2020), who argue that macroprudential tools in their current form are insufficient to deal with large economic shocks. They therefore recommend, *inter alia*, that regulators to rethink the way in which the CCyB is set, and that its upper band be raised (see also section 5 below).

3. ESRB recommendations

3.1. Addressed to national authorities on reporting and coordination on fiscal measures to address the COVID crisis

As part of its COVID-crisis response, the ESRB issued on 27 May a [Recommendation](#) addressed to national macroprudential authorities on “*monitoring the financial stability implications of debt moratoria, and public guarantee schemes and other measures of a fiscal nature taken to protect the real economy in response to the COVID-19 pandemic*”.

The Recommendation urges stronger cooperation and information sharing among the relevant authorities to allow assessing cross border risks to financial stability stemming from fiscal measures being adopted to counter the COVID crisis. To that end, and whilst avoiding new reporting obligations, the Recommendation asks national macroprudential authorities to monitor the design features and uptake of measures, as well as the possible implications for financial stability using key indicators⁴ and to report that information to the ESRB⁵.

The Recommendation closely follows an earlier [letter](#), dated 14 May 2020, addressed to the Finance Ministers. The content of the letter is similar to that of the Recommendation⁶; it encourages Finance Ministries to cooperate with national macroprudential and supervisory authorities in monitoring the effects on financial stability of fiscal measures, and outlines ESRB plans going forward - in particular, the identification and report on possible financial stability implications derived from fiscal measures for the EU as a whole. In that regard, in its latest macroprudential risk assessment (see section 4 below), the ESRB highlights the resurgence of sovereign risks (as a consequence of current fiscal measures taken to fight the COVID crisis).

On the basis of collected information, the ESRB disclosed [tables of national measures](#) taken. The tables document the extensive heterogeneity of measures regarding their scope, duration and nature. There is no further information on how the ESRB intends to take this work further and namely, whether it is being used to design and calibrate an exit strategy of the COVID-related support measures. In its latest meeting, held on [24 September](#), the General Board received an update on the preliminary results of the Recommendation monitoring exercise and “*underlined that it is important that consequences of the support measures ending too soon, as well as ending too late, are well understood, in particular given the potential cliff effects that could arise*”.

⁴ Some of which are exemplified in the Recommendation, as follows: “*a) Design features and uptake of measures: in particular the volume; types of financial support (such as debt moratoria, loan guarantees, subsidised loans, or equity participations); beneficiaries and eligibility conditions; duration; and information on the use of the measure (e.g. volume and number of applications received and accepted). (b) Implications for financial stability: in particular the flow of credit to the real economy; the liquidity, solvency and indebtedness of the non-financial sector; and the financial soundness of the financial institutions, including observed and expected trends in non-performing loans and the ability to meet liquidity and capital requirements*”.

⁵ The ESRB has prepared templates for reporting information, available [here](#), [here](#) and [here](#).

⁶ In accordance with the ESRB Regulation, the ESRB can address warnings and recommendations also to Member States.

if several measures expire at the same time.". The Board is set to continue monitoring the financial stability implications of fiscal measures taken in reaction to the COVID crisis.

In this context, it is important to bear in mind that EBA issued a [guideline](#) on legislative and non-legislative moratoria on loan repayments⁷ that has recently been discontinued⁸.

3.2. Addressed to the European Commission on Legal Entity Identifier

On 24 September, the General Board of the ESRB issued a [Recommendation](#) addressed to European Commission regarding incorporation of a legal entity identifier (LEI) into EU legislation. The aim of this Recommendation is to promote the use LEI, while paying due regard to the principle of proportionality, which would substantially contribute to achieving the objectives of the Single internal market. The ESRB also recommends to impose: a) necessary obligation for legal entities to report financial information, and b) obligation on authorities to identify legal entities by their LEI when publicly disclosing information.

On 18-19 June 2012, the Leaders of the G-20 [welcomed](#) the recommendations that was put forward by FSB for promoting the use of common identifiers, in particular the LEI and later, in 2017, [welcomed](#) the recommendations for promoting the use of LEI. LEI provides a unique and standardised identification number to legal entities. The common identifier framework was developed for parties to financial transactions, which were encouraged to adopt LEI globally to support authorities and market participants in identifying and managing financial risks. According to the [ESRB](#) *"The use of a unique, exclusive and universal legal entity identifier has increased authorities' abilities to evaluate systemic and developing risks and adopt remedial measures. In particular, the clear identification of contractual parties in a network of global financial contracts processed electronically at a very high speed permits authorities to make use of existing technologies to analyse interconnectedness, identify potential chains of contagion, and track market abuse for financial stability purposes. The LEI has also become critical for connecting existing datasets of granular information on entities from multiple sources."*

Nevertheless, as the FSB [analysis](#) show, *"the LEI has far to go to meet the G20's objective. LEI adoption remains low outside securities and derivatives markets, which limits the ability to effectively support further regulatory uses or to capture positive externalities and maximise network effects to the market as a whole. More efforts should be made both at national and international levels to promote LEI adoption and enhance the benefits to authorities and market participants from its use by addressing identified obstacles. LEI adoption remains uneven across countries. LEI coverage is concentrated in Canada, the EU and the United States (US), where it spans from 2% to 7% of all eligible legal entities, and is much lower elsewhere."*

⁷ The EBA publishes a [compliance table](#) for its moratoria guideline, the most recent update dated 30 October 2020. Most Member States are assessed as compliant.

⁸ The [EBA press release](#) (of 21 September) explains that the measure was exceptional in nature and, considering the circumstances, EBA considered no longer necessary to continue with the policy. EBA guideline allowed banks to grant payment holidays to customers whilst avoiding the automatic classification of exposures under the definition of forbearance or as defaulted under distressed restructuring.

4. Risks and their assessment

4.1. Risks identified by the ESRB

In their 2019 [Annual Report](#), the ESRB has reviewed and updated the list of systemic risks taking into account the new risk landscape resulting from the pandemic outbreak. The table below provides a summary of all the risks identified by the ESRB and their respective valuation (taking into account both the probability of materialisation and potential impact). As Europe is still in the midst of the pandemic crisis, the systemic risks directly related to the COVID-19 pandemic are listed as denoting elevated or severe systemic risk.

Table 1. ESRB risk assessment as at 25 June 2020

	Risk	Systemic risk originating from
Systemic risks directly related to the COVID-19 pandemic	1	Widespread defaults in the private sector due to deep global recession
	2	Difficult macroeconomic environment for banks, insurers and pension schemes
	3	Re-emergence of sovereign financing risk and debt sustainability concerns
	4	Instability and pockets of illiquidity in financial markets
Other systemic risks	5	System-wide cyber incidents
	6	Finance-driven disruptions in critical financial infrastructure
	7	Materialisation of large environmental shocks

Source: [ESRB Annual Report](#).

Notes: The ESRB’s risk assessment and policy priorities cover the EU and European Economic Area (EAA) as a whole and have a horizon up to three years. The second column shows the prioritisation of risks, with yellow denoting systemic risk, orange denoting elevated systemic risk and red denoting severe systemic risk. This colour coding is a function of both the probability of materialisation of the risk and of its potential impact. It also takes into account the regulatory framework at the time of the risk assessment.

The ESRB points out the following risks relating to the pandemic:

*“First, reflecting the economic impact of the pandemic, the ESRB risk assessment sees the **biggest source of systemic risk as originating from the real economy**. This reflects a weak recovery that further reduces cash flows and weakens financial positions of corporations and households, eventually leading to the risk of a large number of defaults, a rise in unemployment and economic imbalances (Risk 1). Second, the ESRB assigned elevated severity to the risk from the **difficult macroeconomic environment for banks, insurers and pension schemes** (Risk 2). [...] Third, the ESRB assigned an elevated severity to the **re-emergence of sovereign financing risk and debt sustainability concerns** (Risk 3). This source of systemic risk reflects the expected increase in public deficits implied by the numerous national support measures adopted during the COVID-19 crisis in order to limit private sector defaults (which include, notably, state-guaranteed loans). [...] Fourth, the ESRB assigned an elevated severity to the **risk of instability and pockets of illiquidity in financial markets** (Risk 4). The flight-to-safety in financial markets caused large declines in equity indices and in the prices of other assets, including many EU sovereign bonds. This reassessment of risk premia is one of the risks the ESRB and many of its members have repeatedly highlighted in recent years.”*

In addition to the above mentioned systemic risks, the ESRB has [highlighted](#) the following systemic risks that are relevant to non-bank financial intermediation (NBFi) sector: *“(i) a global recession and sharp contraction of economic activity in the EU; (ii) rising indebtedness, increased credit risk and the risk of rating downgrades; (iii) high uncertainty and risks associated with a low-for-longer interest rate environment; and (iv) low liquidity and high volatility in some markets”*. Furthermore, the ESRB names several structural risks that require ongoing monitoring, namely: *“(i) risk-taking, pricing uncertainty, liquidity risk, and risks associated with*

leverage among some types of investment funds and [other financial institutions]; (ii) domestic and cross-border interconnectedness and the risk of contagion across sectors and within the non-bank financial system; (iii) activity-related risks including procyclicality, leverage and liquidity risk created through the use of derivatives and securities financing transactions; and (iv) data gaps including the need to develop new and improved risk metrics as new datasets become available”.

The Financial Stability Board (FSB) has also been actively [involved](#) in analysing the lessons learned from COVID-19 outbreak and working on understanding the vulnerabilities in NBFIs⁹, prescribing reasonable policy solutions, and monitoring the implementation and effectiveness of any agreed-upon reforms.

In its [2020 Annual Report](#) on *Implementation and Effects of the G20 Financial Regulatory Reforms*, the FSB cautions that implementation reform is still at early stages and that progress in incentive alignment in securitisation is uneven across its membership, but that authorities have taken steps during the COVID-crisis that may have more structural positive effects going forward. It underscored, nevertheless, that market turmoil linked to the COVID crisis has reinforced the need to better understand the nature of liquidity risks in the financial system and vulnerabilities in NBFI.

Box: Macroprudential policy measures beyond banking

As the ESRB well summarised in their [Strategy paper](#), “these sources of risk transcend sectoral boundaries. For example, while excessive leverage has been associated with banks, it can also be created outside the banking sector through collateralised lending, such as securities financing transactions (SFTs), or through collateralised mortgage financing. Banks and non-banks can also create excessive leverage synthetically through the use of derivatives.” As financial intermediation and other financial services beyond banking (namely, the entities covered by the Non-Bank Financial Intermediation, NBFI, definition) could be a source of financial instability, the policy makers should be equipped with a set of macroprudential instruments that would help to mitigate this shifted or new systemic risks in a non-banking sector. Same as for banking sector, addressing risks beyond banking requires a mix of macroprudential instruments that apply to both lenders and borrowers, targeting entities and activities and needs to be designed taking into account the specificities of each of the relevant sectors. The recent review of the ESRB mandate clarified its broad mandate, encompassing monitoring and assessment of systemic risk beyond the banking system.

More recently, and as noted in its latest annual report, the ESRB focused on macroprudential implications of financial instruments in [Level 2 and 3 for accounting purposes](#); mitigating the systemic risk stemming from the [procyclicality of margins and haircuts](#); and on [enhancing the macroprudential dimension of Solvency II](#). Moreover, the ESRB recalled its [letter](#) to the European Commission on the shortcomings of the current Alternative Investment Fund Managers framework. The ESRB also highlights its ongoing work on developing the [concept of macroprudential stance](#).

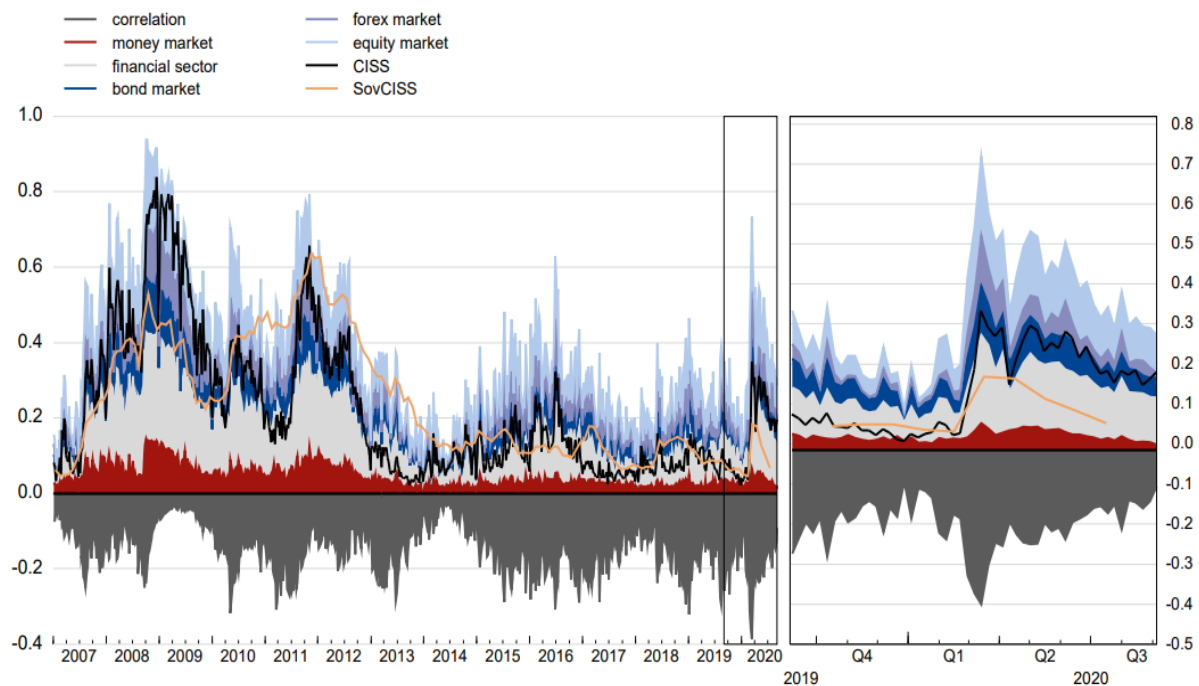
On 13 November, ESMA published a [report](#) addressing the preparedness of investment funds with significant exposures to corporate debt and real estate assets for potential future adverse liquidity and valuation shocks. The Report identifies five priority areas for action which would enhance the preparedness of these fund categories: (a) ongoing supervision of the alignment of the funds’ investment strategy, liquidity profile and redemption policy; (b) ongoing supervision of liquidity risk assessment; (c) fund liquidity profile reporting; (d) increase of the availability and use of Liquidity Management Tools (LMTs); and (e) supervision of valuation processes in a context of valuation uncertainty. The report follows up on a May 2020 ESRB recommendation to ESMA.

⁹ The FSB latest [report](#) on NBFI reflects developments in the sector, to a large extent less significant than in previous years. Main findings from the 2019 monitoring (with data of end-2018) exercise include (a) total global financial assets of the NBFI grew by 1.4% to \$378.9 trillion in 2018, driven largely by banks; (b) the narrow measure of NBFI grew by 1.7%, to \$50.9 trillion in 2018, significantly slower than the 2012-17 average annual growth rate of 8.5%; (c) collective investment vehicles susceptible to runs grew by 0.4% in 2018, much slower than the 11% average annual growth rate from 2012-17; (d) lending by Other Financial Institutions (OFIs) has continued to grow (by 3.0% in 2018, largely driven by the euro area). Interconnectedness between banks and OFIs through credit and funding relationships has been largely unchanged since 2016. Investment funds and money market funds remain the largest OFI providers of credit to banks.

As it was highlighted in the latest ESRB Risk dashboard [overview](#) (1 October 2020), the market-based indicators of systemic stress have continued decreasing after a sharp systemic stress increase in the end of 1st quarter of 2020 following the outbreak of the pandemic.

Figure 1. Composite indicator of systemic stress

(Last observation: 4 September 2020)



Sources: [Thomson Reuters](#), [ECB](#) and [ECB calculations](#).

Notes: The CISS is unit-free and constrained to lie within the interval (0, 1). See Hollo, D., Kremer, M. and Lo Duca, M., "CISS - a composite indicator of systemic stress in the financial system", Working Paper Series, No 1426, ECB, March 2012. The Sovereign CISS applies the same methodological concept of the CISS. On aggregation of different measures of stress in different euro area sovereign bond markets see Garcia-de-Andoain, C. and Kremer, M., "Beyond spreads: measuring sovereign market stress in the euro area", *Economics Letters*, Vol. 159, 2017, pp. 153-156.

4.2. Risks identified by other institutions

A [report](#) published in September 2020 by the Joint Committee of European Supervisory Authorities (ESAs), highlighted that the outbreak of COVID-19 brought unprecedented social and economic challenges with inevitable impact on the EU financial sector. Namely, in the short-medium term, valuation, liquidity, credit and solvency risks have increased (especially, profitability concerns for the entire financial sector became further amplified, and the EU investment fund industry faced significant deterioration of asset quality and witnessed substantial outflows). As a result, it is expected to result in deteriorating asset quality of the EU banking sector. In the medium-long term, low interest rate environment poses serious threats to the profitability and solvency of financial institutions, as well as coverage and funding ratios of EU institutions for occupational retirement provisions.

In the current circumstances, the Joint Committee of ESAs identified risks that the financial sector is facing and advised national competent authorities to take the following policy actions:

*"1. Given the high uncertainty regarding economic and market developments, **financial institutions should be prepared for possible further market corrections and deterioration in financial market liquidity**. In this context, financial institutions and supervisors should take into account various scenarios and, for example,*

perform stress testing or sensitivity analyses¹⁰ in order to map the impact of potential shocks [...] In addition, financial institutions cannot fully rely on their existing risk management frameworks, as they may not sufficiently take into account the unique characteristics of this crisis for managing their risks.

2. The impact of the crisis on bank asset quality is expected to be a key challenge going forward. Banks and supervisors should properly assess the quality of loan portfolios and also consider in their preparations that widely introduced legislative and non-legislative loan moratoria, as well as further policy measures such as loan guarantee schemes, are of a temporary nature.

3. Given the overall uncertainty of the scale and duration of the crisis, **it is important that the financial sector remains well-capitalised.** Financial institutions should ensure that the assessment of their capital positions is forward-looking and that it takes into account current uncertainties, following prudent dividend and other distribution policies, including variable remuneration¹¹. At the same time, supervisors and banks should make use of the flexibility embedded in the existing regulatory framework, including to use capital and liquidity buffers to absorb losses, and thus to ensure continued lending to the economy.

4. Monetary policy responses to the crisis entail an even longer low interest rate environment. **Supervisors and financial institutions need to accommodate a further prolonged “low-for-long” interest rate environment and its risks, including addressing overcapacities in the financial sector.** While low interest rates are important to support economic activity, they negatively impact bank profitability and remain the main risk for the life insurance and pension fund sector. They contribute to the further build-up of valuation risks in securities markets through search-for-yield strategies, which underestimate risks, and have contributed to bank lending growth in riskier segments.

5. It is key for financial institutions and their service providers to carefully manage their ICT and security risks, including when outsourcing ICT activities. They should ensure that appropriate technologies and adequate resources are in place to address data integrity, business continuity and increasingly sophisticated cyber threats. Institutions should also pay particular attention to a growing number and new forms of financial crime in this period of large economic turmoil.”

The IMF [Global Financial Stability Report](#) published in June 2020 highlighted that various financial system vulnerabilities became apparent and may still crystallise as a result of the pandemic. A disconnect between financial markets and developments in the real economy poses a threat to the recovery if investor risk appetite would fade. Despite a soar in risk asset prices, market access for some countries has dried up and they are facing refinancing risks. Also, highly indebted both public and private sector borrowers might face challenges in repaying their loans, which would result in growing number of insolvencies and could even lead to a need of bank resolution or restructuring. Last but not least, as most of the countries have reprogrammed their existing budgets, activated contingency reserves and adopted supplementary budgets, the IMF [raised concerns](#) that “the rush to set up the pandemic response funds has led in some cases to a legal vacuum, in which the purpose, management structures and oversight mechanisms of the funds are not sufficiently defined”.

Moreover, in its recent [World Economic Outlook](#), the IMF has tried to shed some light on “the nature of the recession and to provide insights into the strength of the upcoming recovery. If lockdowns were largely responsible for the economic contraction, it would be reasonable to expect a quick economic rebound when they are lifted. But if voluntary social distancing played a predominant role, then economic activity would likely remain subdued until health risks recede.”

The analysis suggests that “the contribution of voluntary distancing in reducing mobility was stronger [economic effect] in advanced economies.” The IMF warns that due to continuing voluntary social distancing, it is unlikely that lifting the lockdowns would rapidly bring the economic activity back to its potential and

¹⁰ See bank sector sensitivity analyses on credit risk, market risk and revenue sensitivities in EBA thematic note “[The EU banking sector: First insights into the COVID-19 impacts](#)”.

¹¹ See EIOPA [statement](#), EBA [statement](#) and ESRB [Recommendation](#).

these results are especially valid if lockdowns are lifted when infections are still relatively high (please see a dedicated EGOV [briefing](#) on recent economic forecasts and risks associated for more information).

5. Other macroprudential concerns and risks

5.1. Macroprudential inaction risks

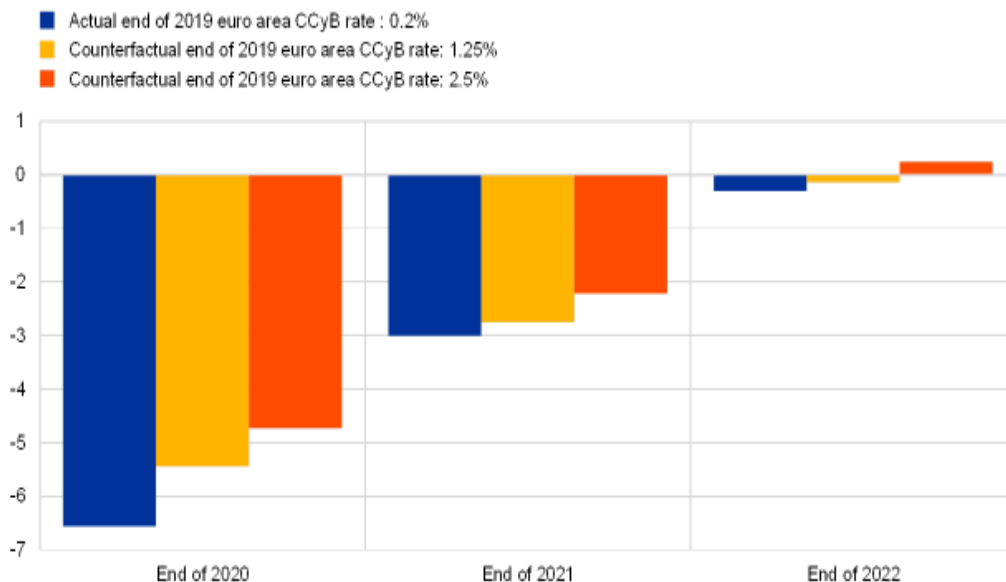
In April 2020, the ESRB [pointed](#) to the fact that only a few Member States took measures to address financial stability risks in the commercial real estate sector, as well as, lack of macroprudential tools to address high risks related to banks' lending to non-financial corporations. Furthermore, not all Member States have previously accumulated macroprudential policy capacity that could be used during the crisis in order to help financial sector to cushion the adverse pandemic outbreak shock.

The results of a recent vulnerability [analysis](#) performed by the ECB revealed that *“Had authorities built up larger countercyclical buffers (CCyB) before the pandemic, it would have been easier to release usable capital in response to the crisis [...] Creating macroprudential space by enhancing countercyclical capacity [via proactive use of the CCyB] can effectively complement monetary policy actions during a crisis – particularly when constrained by the effective lower bound on interest rates – and thereby improve the policy mix available to achieve better macro-financial stabilisation.”*

In their recent Macroprudential Bulletin, the ECB has [published](#) model-based simulation results showing that a more aggressive build-up of the CCyB before the coronavirus pandemic would have shielded the economy better. The graph below shows the projected path of the euro area real GDP (expressed in percentage deviation from the 2019 level) after the lockdown induced shock to the economy. The different colours of the bars represent different assumptions about the CCyB level: a) blue bars show the future projected economic developments (central scenario forecast as published in the June 2020 Eurosystem staff macroeconomic [projections](#)) with actual build-up of CCyB (of about 0.2% at the end of 2019); b) yellow bars represent estimated economic developments if the CCyB level would have been 1.25% at the end of 2019; and c) red bars represent estimated economic developments if the CCyB level would have been 2.5% at the end of 2019.

Figure 2. Real GDP for different levels of countercyclical capacity

(percentage deviation of real GDP level from baseline projection with actual pre-crisis CCyB)



Source: [Simulations](#) based on Darracq Pariès, Kok and Rottner (2020).

Note: The GDP path depicted for the series “Actual euro area CCyB rate at end of 2019: 0.2%” corresponds to the June 2020 Eurosystem staff macroeconomic projections (central forecast).

Higher CCyB buffers leading up to the corona virus crisis would have supported the resilience of the corporate sector, during the recession, leading to a less severe contraction in 2020 (real GDP contraction could have been less pronounced by around 1% to 1.75% in 2020, 0.25% to 0.75% in 2021 and 0.1% to 0.4% in 2022 depending on CCyB accumulated pre-pandemic); also more and differently distributed capital could have been released without triggering Maximum Distributable Amount (MDA) restrictions, exposing banks to stigma effects. Higher pre-crisis macroprudential capital buffers would have also contributed positively to bank credit growth by around 2.0% to 4.5%. Last but not least, a banking sector with more releasable capital enhances monetary policy transmission by increasing the effectiveness of the bank lending channel.

Given the complex distribution of macroprudential powers among national and European institutions (please see a dedicated EGOV [briefing](#) on the institutional set up of the macroprudential policy in the EU), the ESRB has no legal powers to address the build-up of systemic risks (only to raise awareness through issuing Recommendations and Warnings), as the activation of macroprudential policy instruments is entrusted to national macroprudential authorities with limited “top-up” powers on activated macroprudential measures that are granted to the ECB (it should be noted that the “top-up” powers granted to the ECB have not been used so far).

5.2. Market’s behavioural changes

Due to economic downturn and very high uncertainty related to the recovery, the majority of the market participants have changed their usual behaviour. Such change in behaviour creates potential risks to policy transmission channels and could have unanticipated side effects to a wide range of COVID-19 related support measures.

First, as it is quite usual for crisis periods, households had started to accumulate more precautionary savings, as the ECB has highlighted in their recent [Economic Bulletin](#), “*the propensity of households to save has reached unprecedented levels in response to COVID-19*”.

Second, both households and corporations have postponed their investments. The ECB in the above mentioned Economic Bulletin have also pointed out that “*consumers tend to hold off making purchases during a recession, they build up a backlog of demand that is unleashed when signs of economic recovery emerge [...] nearly half of the contraction in private consumption reflects expenditure components which could be postponed (e.g. electronics, cars)*”. Furthermore, the ECB [Bank Lending Survey](#) for the third quarter of 2020 has revealed that corporate sector demand for fixed investment, mergers and acquisitions, inventories and working capital have significantly deteriorated.

Last but not least, an ECB [study](#) shows, banks have a strong tendency to keep higher capital buffers well above the regulatory minimum. The ECB has observed reactions of 35 banks in the euro area to the COVID-19 related capital relief by prudential authorities and almost two thirds of the sample have either maintained their self-imposed capital buffer target close to their actual CET1 ratio or have not changed their capital ratio targets. Such reluctance to lower internal targets can be at least partially explained by the uncertainty surrounding the future path and expected increase in provisions needed for non-performing loans.

5.3. Stress tests design

In January 2020, the EBA has launched a public consultation on reviewing the [design of EU-wide stress tests](#). The EBA proposals included (i) restating the purpose of the EBA stress test as a primarily microprudential exercise, and (ii) replacing the current design in which banks and (microprudential) supervisors share ownership of the results (as the two parties iterate before arriving at the supervisory-validated results) with a two-leg design¹². The reviewed EU-wide stress test design was expected to also take into account the

¹² In the supervisory leg, supervisors would have greater discretion to introduce bank-specific adjustments and would publish a more limited range of results than under the current design, with the main objective being the estimation of the capital deficits necessary for calibrating their pillar 2 capital guidance requirements. In the bank leg, individual banks would have greater flexibility in the use of their own methods and data

comments raised by the European Court of Auditors in its 2019 special report on stress tests¹³. Nevertheless, following consultation with the industry, the EBA is expected according to their [16 September](#) meeting, to work on an alternative to the two leg approach proposed in January and to focus on developing a hybrid approach with more topdown elements and on increasing realism of the exercise in order to better address its purpose. Such methodology will take some time to develop.

A recent ESRB [ASC Insights paper](#) by Javier Suarez and Willem Buiters, both Advisory Scientific Committee members, discusses EBA's January proposals. The authors argue that such proposals would "*unnecessarily narrow down*" the scope of the stress tests, "*condition their future development and potentially induce some duplication of information gathering costs in order to satisfy macroprudential authorities' needs that might no longer be met properly*" and could give rise to "*more abundant but less reliable and comparable – that is, less useful – information. This could occur if the supervisory leg turned out to be more opaque and were to disseminate less granular results than the current framework, while the greater flexibility and reduced quality assurance in the bank leg would decrease the comparability of the results across banks and increase the margin for misrepresentation.*" The authors argue, in fact, in favour of a hybrid model.

The decision by EBA in [March 2020](#) to postpone the stress test exercise will require the ESRB to re-design the adverse scenarios prepared ahead of the 2020 stress tests. Such adverse scenario will necessarily take into account the impact and effects of the COVID-19 crisis, as explained in [ESRB 2019 Annual Report](#). The EBA is [expected to launch](#) the 2021 stress test exercise at the end of January 2021 with results to be published at the end of July 2021. On [13 November](#), the EBA published the final methodology, draft templates and template guidance for the exercise.

5.4. Monitoring of Brexit related risks

Prior to the COVID-19 crisis, the ESRB had [identified](#) a hard Brexit as a potential trigger for the repricing of risk premia in global financial markets, and considered this a high risk to financial stability. Moreover, in its [review of macroprudential policy in 2019](#), the ESRB highlighted the risks to financial stability arising from potential loss of access to financial market infrastructure, including central counterparties (CCPs). Since then, however, the European Commission [adopted](#) a time-limited decision on an equivalence of UK CCPs.

In order to assess and quantify Brexit-related financial stability risks in the derivatives markets, the ESRB [developed](#) a daily EU derivatives market monitor based on transaction-level data under the reporting framework established by the European Market Infrastructure Regulation. Using this data, the ESRB created daily snapshots of the development of cross-border activity in derivatives between the EU and the UK. Such granular data is used to facilitate decision-making and dialogue amongst the ESRB community on issues of systemic relevance. The ESRB has [indicated](#) that it will "*continue its work in this area by expanding its infrastructure and enriching its monitoring tools with newly available data*".

to produce results that would cover a similar range of granular information as under the current framework, but they would be subject to less intense quality assurance by their supervisors.

¹³ See the 2019 European Court of Auditors [special report](#) "*EU-wide stress tests for banks: unparalleled amount of information on banks provided but greater coordination and focus on risks needed*", where the Court concluded, in relation to scenario setting, that (a) not all systemic risks were taken into account and risks identified were mostly macroeconomic and not bank-sector specific (NPLs, liquidity and institution-specific risks were not considered), (b) ESRB was given too much discretion in setting the adverse scenario and EBA had only a limited and delayed involvement, (c) the adverse scenario in 2018 was less severe than the 2007-2008 financial crisis, (d) limited clarity and consistency in exemptions to the overall methodology.

Annex: List of recent Warnings and Recommendations by the ESRB

Warnings:

- Warning on medium-term vulnerabilities in the residential real estate sector in Norway ([ESRB/2019/14](#))
- Warning on medium-term vulnerabilities in the residential real estate sector in Iceland ([ESRB/2019/13](#))
- Warning on medium-term vulnerabilities in the residential real estate sector in France ([ESRB/2019/12](#))
- Warning on medium-term vulnerabilities in the residential real estate sector in Germany ([ESRB/2019/11](#))
- Warning on medium-term vulnerabilities in the residential real estate sector in Czech Republic ([ESRB/2019/10](#))

Recommendations:

- Recommendation on identifying legal entities ([ESRB/2020/12](#))
- Recommendation on monitoring the financial stability implications of debt moratoria, and public guarantee schemes and other measures of a fiscal nature taken to protect the real economy in response to the COVID-19 pandemic ([ESRB/2020/8](#))
- Recommendation on restriction of distributions during COVID-19 pandemic ([ESRB/2020/7](#))
- Recommendation on liquidity risks arising from margin calls ([ESRB/2020/6](#))
- Recommendation on liquidity risks in investment funds ([ESRB/2020/4](#))
- Recommendation on exchange and collection of information for macroprudential purposes on branches of credit institutions having their head in another Member State or in a third country ([ESRB/2019/18](#))
- Recommendation on medium-term vulnerabilities in the residential real estate sector in Sweden ([ESRB/2019/09](#))
- Recommendation on medium-term vulnerabilities in the residential real estate sector in Finland ([ESRB/2019/08](#))
- Recommendation on medium-term vulnerabilities in the residential real estate sector in the Netherlands ([ESRB/2019/07](#))
- Recommendation on medium-term vulnerabilities in the residential real estate sector in Luxembourg ([ESRB/2019/06](#))
- Recommendation on medium-term vulnerabilities in the residential real estate sector in Denmark ([ESRB/2019/05](#))
- Recommendation on medium-term vulnerabilities in the residential real estate sector in Belgium ([ESRB/2019/04](#))
- Recommendation on closing real estate data gaps ([ESRB/2016/14](#) and [ESRB/2019/3](#))

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