BRIEFING

European Parliament

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

ECON on 8 June 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 on 8 June 2020. This will be the first hearing with Ms Lagarde in her capacity as a Chair of the ESRB. The aim of the meeting is to discuss recent developments in macroprudential policy field and the impact of the corona crisis.

The briefing addresses the ESRB and national macroprudential authorities' response to the pandemic outbreak, including recent ESRB Recommendation to ESMA; latest ESRB systemic risk assessment and other macroprudential policy concerns.

1. Macroprudential policy response to COVID-19 outbreak

The ESRB has a central role to ensure policy coordination between different macroprudential authorities in the EU and limit any negative spillovers of national actions to the EU's Single Market. The ESRB General Board underlined than in the context of the pandemic "*that a timely and coordinated policy response is key, in particular to achieve important synergies between fiscal, monetary and regulatory policies*" and has therefore decided to focus on five priority areas in order to address the impact of the pandemic emergency:

- **Implications for the financial system of guarantee schemes and other fiscal measures to protect the real economy.** As EU Member States take measures in response to support the real economy and insofar such measures may have important macroprudential implications for the financial sector, the ESRB strongly encourages cooperation and information exchange between national authorities.

- **Market illiquidity and implications for asset managers and insurers.** According to the ESRB analysis, if the macroeconomic outlook worsens by more than is currently anticipated, investment funds and insurers with large exposures to corporate debt and real estate may have further redemption pressures, which could lead to further spillovers to other financial institutions and the real economy. In this context, the General Board adopted a Recommendation to the European Securities and Markets Authority (ESMA), which is discussed in Section 2.

- **Impact of large scale downgrades** of bonds on markets and entities across the financial system. The ESRB published an analytical note overviewing the current situation

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and decided to coordinate a joint analytical exercise together with European Supervisory Agencies and the European Central Bank (ECB), in order to assess the impact of a large-scale credit rating downgrades across all parts of the financial sector[1].

- **System-wide restraints on dividend payments, share buybacks and other payouts.** The General Board supports actions taken so far as they help reduce the risk of financial institutions failing, enhance the resilience of financial sector, increase the capacity to lend to the economy and help remove potential stigma attached to the decision of capital preservation. The macroprudential and systemic impact of such actions - namely on large institutional investors holding large banking portfolios such as pension funds, would need to be addressed.

- **Liquidity risks arising from margin calls.** The ECB's recent Financial Stability Review of May 2020 indicates that in March 2020 margin calls on funds increased fivefold and this is an area where swift action may indeed be needed. Margin calls could further increase due to credit rating downgrades and possible market volatility. Given such background the ESRB stressed the importance of (i) mitigating procyclicality that could be linked to the provision of clearing services and to the exchange of margins in bilaterally cleared markets; (ii) enhancing central counterparty stress test scenarios for the assessment of liquidity needs; and (iii) limiting excessive liquidity constraints related to margin collection. The impacts of bilateral margin calls may be somehow mitigated by the European Supervisory Authorities' (EBA, EIOPA and ESMA) recent proposal of incorporating a one-year deferral of the two implementation phases of the bilateral margining requirements under the European Markets Infrastructure Regulation (EMIR).

On top of microprudential supervisory measures announced by the ECB and national supervisory authorities, the national macroprudential policy authorities has also taken measures in response to the coronavirus pandemic. A number of Member States have fully or partially released countercyclical capital buffers (BE, BG, CZ, DE, DK, FR, IE, LT, SE) and/or systemic risk buffers (AT, EE, FI, IE, NL, PL) that have been accumulated before; some Member States allowed national systemically important institutions to disrespect macroprudential capital buffers applied specifically for them (namely, the other systemically important institution capital buffer; AT, FI, HU, LT, NL, PT), as well as, relaxed some of the other macroprudential policy measures (a detailed list of all national measures can be found on the ESRB website).

2. ESRB recommendation to ESMA

On 6 May, the ESRB issued Recommendation addressed to ESMA, which was "*designed to enhance preparedness to respond to potential future adverse shocks that could lead to a deterioration in financial market liquidity, resulting in potential adverse implications for financial stability conditions in the Union*". With this Recommendation, the ESRB suggested to carry out a coordinated supervisory exercise involving investment funds[2], especially the ones with large exposures to corporate debt and to real estate, to assess the preparedness to potential future adverse shocks. The Recommendation requests ESMA to submit their analysis and conclusions reached after this exercise by 31 October 2020.

In their response, published at the same time as the Recommendation itself, ESMA highlighted the already ongoing coordination and the intensified exchange of information among national

[1] ESMA, as the EU supervisor of credit rating agencies (CRAs), reports being closely monitoring rating actions through enhanced data analytics to assess the possible impact of ratings actions on financial stability and actively sharing that information with national competent authorities and other stakeholders. Furthermore, ESMA points out that it is discussing CRA actions in the context of COVID-19 with regulators around the globe.

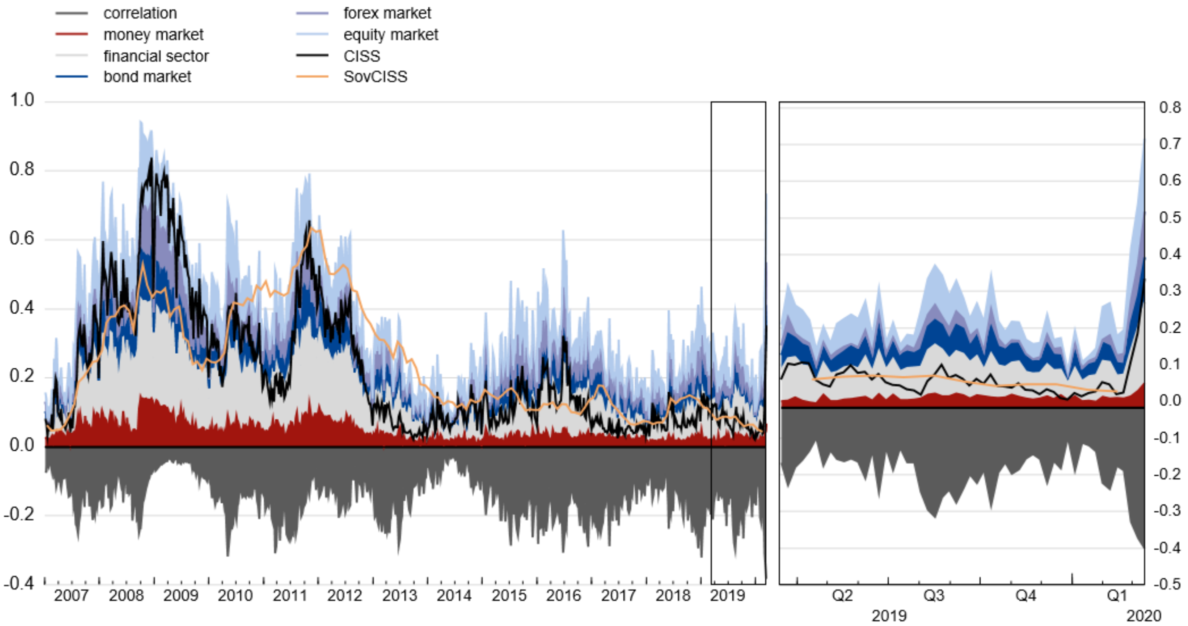
[2] Specifically, an undertaking for collective investment in transferable securities (UCITS) as defined in Article 1(2) of Directive 2009/65/EC that has been authorised in accordance with Article 5 of that Directive; and an alternative investment fund (AIFMD) as defined in Article 4(1)(a) of Directive 2011/61/EU.

competent authorities on the use of liquidity management tools, which took place due to the COVID-19 pandemic. Nevertheless, ESMA welcomed public communication on the importance of the timely and effective use of liquidity management tools by investment funds with exposures to less liquid assets and will carry out the coordinated exercise involving National Competent Authorities, ESRB, ECB, European Banking Authority, European Insurance and Occupational Pensions Authority.

3. Risk assessment

As it is highlighted in the latest ESRB Risk dashboard overview (9 April 2020), the unknown depth and length of the coronavirus pandemic has created significant uncertainty regarding economic outlook and related risks. As result, the market-based systemic stress indicators have increased sharply after the outbreak of the coronavirus (see Figure 1). Sharply increasing sovereign CDS premia (particularly for countries with weaker fiscal fundamentals) reflected rising market participants' concerns over increasing sovereign risks. EU banks' and insurers' equity prices and other instruments were also affected by the coronavirus outbreak and have declined sharply.

Figure 1. Composite indicator of systemic stress
(Last observation: 13 March 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.

Other systemic risk developments covered in the ESRB Risk dashboard:

Credit risk. The option-adjusted spreads on euro area corporate bonds have been strongly affected by the economic crisis triggered by the COVID-19 pandemic. As a result, between the end of February and the beginning of March the high-yield bond spread widened significantly, gaining around 500 basis points in half a month, while the other two spreads grew by about 100 points.

Residential real estate prices continued to rise considerably in all but one EU Member State. In the third quarter of 2019 year-on-year growth in residential real estate prices continued to exceed 5% in the majority of EU Member States, following significant price increases over the previous three years. Reflecting these dynamics, based on various valuation methods, residential real estate prices appear to be overvalued in several EU Member States.

Banks. Banks' profitability in the European Union decreased in the fourth quarter of 2019. The median return on equity stood at 5.8%, while return on assets was 0.4%. At the same time, the median cost-to-income ratio increased slightly over its third-quarter 2019 value, to stand at 63.2% for the fourth quarter of 2019.

Banking sector capitalisation stood broadly unchanged and the reduction of non-performing loans improved slightly. The median ratio of Common Equity Tier 1 (CET1) to risk-weighted assets remained broadly stable at 15.6% in the fourth quarter of 2019. At the same time, the median ratio of non-performing loans to total gross loans and advances was around 2.6% in the fourth quarter of 2019, falling by 10 basis points compared with the previous quarter.

Insurance. The median solvency ratio of the EU insurance sector deteriorated by around 10 percentage points to roughly 185%. The median combined ratio for non-life insurance remained stable, standing at just above 95%.

Regarding the EU insurers' asset allocation, there were no significant changes in the credit quality characteristics of EU insurers' bond portfolio, but the liquidity profile of assets deteriorated slightly for some insurers. The EU insurers' holdings of government or corporate bonds remained relatively unchanged, at around 50% of total investments. However, the share of investments made via funds has been increasing slowly. Roughly 80% of these investments have a credit quality below or equal to credit quality step 3 (equivalent to BBB). The median value of EU insurers' asset liquidity remained at around 63%, but the lowest quartile dropped from 53% to roughly 51%.

4. Other macroprudential concerns and risks

Transparency

Some of the measures being taken by supervisors aim at reducing - as far as possible - administrative burdens to alleviate compliance pressure and allow institutions to focus on business continuity. Measures such as the postponing of EBA stress tests (EBA decision on 12.03.2020) or recommendations to postpone disclosure of financial information (see for instance the measures taken by the Financial and Conduct Authority of the UK) are obviously important to address the current crisis but need to be handled carefully to avoid unintended consequences. Asymmetric or uncoordinated disclosure can also contribute to opacity and asymmetry of information. At the same time, supervisors need up-to-date information to assess the situation, and measures have been taken to reinforce coordination and information sharing. ESMA recently advised on corporate reporting disclosures referring to "relevant and reliable information", pointing to using the flexibility available to postpone disclosure, and for entity-specific information on the past and expected future impact of COVID-19 on the strategic orientation and targets, operations, performance of issuers as well as any mitigating actions put in place. EBA, on the other hand, published on 2 June, its "Guidelines to address gaps in reporting data and public information in the context of COVID-19" aiming at addressing data gaps associated with measures taken to mitigate the effects of covid-19 to ensure an appropriate understanding of institutions' risk profile and the asset quality on their balance sheets. The ESRB has a relevant role to play in assisting supervisors to understand the systemic implications of information available and detect data gaps that may arise from the "new" reporting standards.

Macroprudential inaction risks

In their annual Review of macroprudential policy, the ESRB had 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. It should be noted that 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. Given the complex distribution of macroprudential powers among national and European institutions, despite the presence of the above mentioned shortcomings and risks, the ESRB has no legal powers to address them (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.

Moratoria instrument

Fostering a dialogue between macroprudential authorities and fiscal authorities regarding the implications of guarantee schemes and other measures that national and EU authorities have taken to protect the real economy is one of the five priority areas of the ESRB. The ESRB has so far only published a letter, dated 14 May, which sets out the work that the ESRB plans to do about this issue. The letter clarifies that public moratoria are among the instruments considered.

It may be noted in this context that on 2 April 2020, the European Banking Authority already published an EBA guideline on legislative and non-legislative moratoria on loan repayments applied.

The background to that guideline is that in several Member States, legislative and non-legislative moratoria were introduced to ease the pressure for borrowers who struggle with interest payments, instalments, or loan repayments. The EBA writes that those moratoria were in practice adopted in various forms across jurisdictions (some Member States have introduced jurisdiction-wide moratoria based on specific legislation, whereas in many others moratoria have been implemented through voluntary industry-wide or individual initiatives by institutions, or combination thereof), which raises the question of the legal effect they have on the current prudential framework, especially in the context of the application of the definition of default and classification of forbearance.

The guideline therefore sets out which conditions moratoria have to fulfil to ensure that their application does not to trigger a forbearance classification of the debtor.

If a moratorium is meant not to trigger a reclassification of the debtor/underlying loans as benefitting from forbearance, it must notably:

- have a broad scope of application (some sort of scheme),
- be available to a broad range of debtors (large predefined groups, e.g. retail, individuals, and SMEs; it must notably not differentiate between debtors based on their creditworthiness),
- offer the same conditions to all debtors of the same group, and
- only change the schedule of payments, but not change other conditions of the loan, in particular not the interest rate, or waive payments (a significant change in the net present value of the loan would trigger a forbearance classification).

The EBA publishes a compliance table for its moratoria guideline, the most recent update dated 24 April 2020. Unfortunately, that compliance table only gives information on the situation in Bulgaria, Estonia, Lithuania, and Austria (all compliant), while it is blank for all other countries. The lack of newer information on this issue may indicate that the ESRB should indeed foster an intensified dialogue between macroprudential authorities and fiscal authorities about the measures taken to tackle the crisis.

Liquidity risk and margin calls

Liquidity risks arising from margin calls is one of the five priority areas of the ESRB. The ESRB has not yet published a recommendation on this issue.

The ECB's recent Financial Stability Review of May 2020, however, indicates that this is an area where swift action may indeed be needed. The ECB actually reported that in March 2020, margin calls on funds increased fivefold:

"*During the recent coronavirus market turmoil, the daily variation margin calls on funds' derivative exposures rose fivefold. Based on the partial reporting of variation margin in EMIR data, the daily variation margin calls on euro area funds increased from around €2 billion in the first half of February 2020 to over €10 billion in the week beginning 16 March 2020 (see Chart B.2, left panel). The highest increase – by around 6.5 times – was reported on portfolios composed of equity derivatives, followed by interest rate (fivefold increase) and currency (fourfold increase) portfolios. The announcement of the pandemic emergency purchase programme (PEPP) on 18 March 2020 helped reduce market volatility (e.g. as measured by the VIX index for the equity market) and thus contributed significantly to the subsequent decline in margin calls.*"

In the Financial Stability Review, the ECB couldn't indicate the actual size of daily margin calls on funds during the turmoil - instead estimating the order of magnitude to be several tens of billions of euro. The ECB explains this imprecision with the fact that in the EMIR data base, its source, information on the size of margin calls is often missing or not updated on a daily basis.

Short selling bans

Some EU securities markets regulators[3] have temporarily banned short selling of financial instruments since the outbreak of the coronavirus crisis. Even if this was considered necessary to address instability in capital markets, the bans on short selling impact liquidity. ESMA, on the other hand, mandated reporting of short positions at the level of 0.1% (from 0.2%), to facilitate authorities´ assessment of the current situation. Keeping markets open is clearly important (insofar investors are not mislead) and the current legislation foresees instruments to deal with unwarranted price movements, like circuit breakers.

A paper published by the ESRB in 2018 (Beber, Fabbri, Pagano, Simonelli: "Short-selling bans and bank stability"), moreover concludes that short selling bans are even counterproductive: "*Our evidence indicates that short-selling bans are not associated with greater bank stability. In fact, our estimates, even controlling for the endogeneity of the bans, point to the opposite result, namely that bans on short sales tend to be correlated with higher probability of default, greater return volatility and steeper stock price declines, particularly for banks*".

Additional Tier 1 bonds

To enhance capital ratios in the banking sector further, supervisory recommendations could be extended to include the cancellation of coupons for Additional Tier 1 (AT1) bonds. The purpose of AT1 bonds - which form part of the banks' regulatory capital - is exactly to have one additional option to improve capital levels if needed. Bonds therefore only qualify as AT1 if the terms under which they have been issued give the bank "*full discretion at all times to cancel [coupons] for an unlimited period and on a non-cumulative basis*" (CRR Art. 52(l)(iii)).

Such discretion, however, only exists theoretically if banks that use the option are subsequently stigmatised. Stigmatisation could be avoided if the cancellation of AT1 coupons came as a consequence of a general recommendation rather than of an individual decision.

There are legitimate reasons to not consider generally cancelling AT1 coupons: first, the impact is markedly smaller than that of cancelling dividends; second, the impact on AT1 bondholder is different than that on shareholders: while shareholders may be compensated by higher dividends

[3] This is the case of Greece, France, Belgium, Italy, Spain, with differing timeframes. In accordance with the Short Selling Regulation rules, ESMA must issue an opinion on such measures. ESMA opinions can be found here. Some of these measures have elapsed in the meantime.

in the years to come, AT1 bondholders would miss out on the payments for good; and third, forward-looking, there may be a detrimental effect on the future cost of capital, in particular in view of the banking industry's overall low return-on-equity, a setting in which the perceived reliable stream of fixed returns so far made those bonds still attractive on the financial markets.

Yet, proponents argue that "*[...] none of these arguments can really get away from the fact that AT1s are failing to play the role in this crisis that they were specifically designed to play — that of going concern capital.*"

Cyber risk and crime

During the recent years, given a strong progress in technological innovations, increasing digitalisation and interconnectedness in the global financial system, more and more attention had been drawn to a related cyber risks. In their most recent annual report, the ESRB had pointed out that cyber risks is an emerging systemic risk[4] and have analysed the topic in more detail in their report overviewing cyber risks properties, historical events and regulatory responses. Various media outlets have reported that in the wake of the COVID-19 virus, malicious cyber-attacks have intensified; on 24 March, the president of the European Commission, Ursula von der Leyen, also warned that cybercrime in the EU has increased due to the coronavirus outbreak. On a positive note, a number of initiatives have already been launched by standard-setting bodies and authorities[5] in the attempt to tackle cyber risks, among them the recent initiative by the ESRB to enhance the exchange of information on cybersecurity threats and best practices[6]. It remains to be seen how well the financial institutions and supervisors alike are prepared for cyber threats.

Further reading:

Banking Union: Corona crisis effects - Calendar week 22 / 2020

Banking Union: Corona crisis effects - Calendar week 20 / 2020

Banking Union: Corona crisis effects - Calendar week 17 / 2020

Banking Union: Corona crisis effects - Calendar week 15 / 2020

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[4] There are no official data on total costs of cyber incidents, but industry estimates range from USD 45 billion to USD 654 billion for the global economy in 2018.
[5] To name a few: the Financial Stability Board has developed a Cyber Lexicon to help foster the discussion and communication on cyber risk; the ESAs (EBA, EIOPA and ESMA), as well as BIS, have issued guidelines on best practices to be followed; the ECB has established a Cyber Incident Reporting framework. In mid-2019 the G7 started conducting cross-border cyber-attack exercises.
[6] Institutions that participate in this initiative are members of the ESRB, a group of Europe's largest and most important financial infrastructures, Europol and Europe's cybersecurity agency.