BRIEFING

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

ECON on 1 July 2021

This note is prepared in view of a regular public hearing with the Chair of the European Systemic Risk Board (ESRB), Christine Lagarde, which will take place on 1 July 2021. The aim of the meeting is to present the ESRB Annual Report and to discuss recent developments in macroprudential policy field, potential systemic risks looming ahead, notably the impact of the pandemic.

The briefing takes stock of (i) the ESRB and national macroprudential authorities' response to the pandemic outbreak; (ii) summarises recent risk assessments; and takes a closer look at the following topics as potential sources of increasing systemic risk: (iii) corporate insolvency risks, (iv) macroprudential policy implications from low interest rates and (v) macroprudential concerns beyond banking.

1. Macroprudential policy response to COVID-19 outbreak

In order to preserve the stability of the financial system in the face of the recent economic crisis caused by the COVID-19 shock, various fiscal, monetary and regulatory measures have been implemented at the national and the European level (for an overview of the various measures, see EGOV specific briefing). Although the financial system, including major banks and financial infrastructures, entered the crisis more resilient than compared to the Global Financial Crisis, it has still faced severe liquidity stress which required prompt responses in several policy fields, including the use of macroprudential tools.

An ESRB report on the effects of the pandemic from February 2021 summarises their work on financial stability implications of support measures to protect the real economy from the COVID-19 throughout 2020 and the impacts of the various support measures. The key finding of the study is that *"the fiscal response to the COVID-19 shock has stabilised lending but risks still lie ahead"*. More specifically, this overall conclusion is preceded by the following findings:

Short-term stabilising factors (that can cause systemic risk in medium-to-long term):

- Unprecedented and swift support packages were implemented with reported government support amounting to more than EUR 2,400 billion (nominal value, around 14% of EU GDP); households' (HHs) and non-financial corporations' (NFCs) liquidity was largely preserved, and losses were prevented, deferred or shifted through public guarantees, direct grants and moratoria. These measures ensured financial stability due to both direct and indirect linkages of financial institutions with other sectors, i.e. since financial institutions act as direct counterparties or have an ownership relationship with HHs and NFCs *(direct linkages)* and because these

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institutions are exposed to common economic risks *(indirect linkages),* hence potentially creating systemic risks;

- Credit markets were strongly supported by fiscal policy *as "one-third of new commitments provided by banks to NFCs benefited from public support*". Due to strong policy support, loan losses remained limited, and increases in non-performing loans (NPLs) and forborne loans were smaller than expected at the beginning of the crisis;

Medium-to-long term risk factors:

- As corporate insolvencies are expected to rise, it would expose financial sector balance sheets to spillover risks (see Section 3), which would result in higher losses for banks and requires prompt provisioning; at the same time, the support measures have shielded banks' balance sheets and the full effects are still to materialise or be visible;
- There is a risk of potential adverse feedback loops if banks rely on deleveraging rather than on using available capital buffers to meet target capital requirements as such action would constrain the credit flow to the economy (see Box 1). Since *"loans by foreign entities in the euro-area amount on average to 40% of total lending to domestic households and NFCs",* there is a risk that cross-border lending activities might become negatively affected by the COVID-19 shock;
- A trade-off between supporting the economy and not maintaining the support for too long is present: *"Lifting support too soon could exacerbate the effects of the economic crisis, while maintaining it for too long would increase budgetary pressures and affect competition in the real economy".*

Furthermore, the ESRB report emphasises the need to avoid cliff effects when it comes to the withdrawal of measures, as this could lead to adverse feedback loops, increasing the probability of banks' deleveraging and affecting their balance sheets through loan losses. Conversely, a late withdrawal may result in a build-up and masking of underlying weaknesses in banks and borrowers.

Therefore, the ESRB suggests that policy responses should be more coordinated at both the national and the EU level and that **fiscal measures should become more targeted** by supporting viable businesses and promoting growth. Nonetheless, debt sustainability needs to be monitored due to high indebtedness resulting from public guarantees and moratoria. Institutions administering the restructuring and insolvency processes should prepare for an adverse scenario and, thus, not reach their capacity constraints and administer NPLs timely and effectively. Credit risk should be early and properly recognised to improve the transparency of banks' balance sheets and avoid undue delays in identifying borrowers' long-term payment problems [1].

Moreover, trade-offs regarding extending, amending and ending COVID-19 support measures are discussed in [a recent report] (April 2021) by the Financial Stability Report (FSB). Even though, as the FSB points out, *"quantitative assessments of the impact of the withdrawal of COVID-19 support measures are still rather limited in number"*, which implies that robust conclusions and lessons learned could not yet been drawn. Nevertheless, the FSB argues that a premature withdrawal of support measures could harm the financial system more significantly than maintaining them for too long, consistently with recommendations from other international institutions [2].

On the one hand, the above mentioned FSB Report warns of possible adverse procyclical effects linked to the lifting of measures before the macroeconomic outlook has stabilised, which could reduce economic

[1] In particular, the ESRB notes that "*The longer the impact of the COVID-19 shock persists, the more important the transparency of banks' balance sheet information becomes. This holds especially true in the light of the challenges relating to credit risk models and the temporary adaptations of prudential rules*", insofar "*Credit risk models used for risk quantification are calibrated based on historical time series and are not designed to deal with the large-scale disruptions of a pandemic* (...)".

[2] See, as an example, the International Monetary Fund recommendations on balancing risks of a premature withdrawal of support measures.

growth potential in the long run and affect banks' balance sheets through increases in NPLs. Early fiscal, monetary and regulatory support withdrawals could also *"risk a sudden adjustment in asset prices and an increase in borrowing costs"*, as well as *"create negative international spillovers, which are likely to be more material in adverse scenarios with cliff effects."* On the other hand, maintaining support measures for an overly extended period could eventually pose risks to financial stability by *"distorting resource allocation and asset prices, increasing moral hazard, postponing necessary structural adjustment in the economy and draining fiscal resources."* Credit quality could also deteriorate over time, and debt overhang might become an issue, subsequently hindering investment and growth.

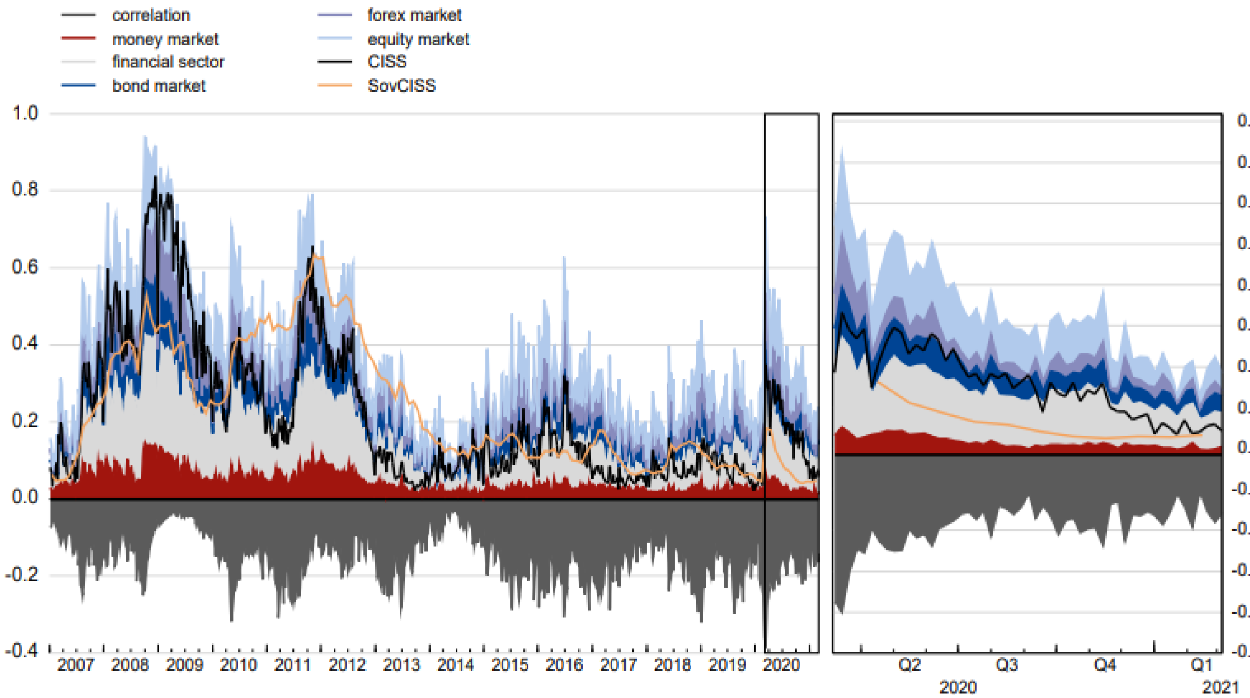
In this regard, the FSB advises policymakers to adopt a flexible, state-contingent approach and withdraw measures gradually by implementing specifically targeted measures, requiring beneficiaries who truly need support to opt-in for measures, tightening support conditions over time, and sequencing lifting of different support measures. The FSB also emphasises the importance of clear, consistent and timely communication about policy intentions in order to enable a smoother adjustment of the economy with lower associated costs and fewer adverse effects associated with inadequate policy communication, as well as adequate sharing of information. Concerning the role of supervisors, the FSB argues *for "the right balance of flexibility and sound credit risk management"* due to the vital role of a resilient and well-functioning financial system in the economic recovery through lending to the real economy. Supervisors should ensure that banks monitor the economic health of their borrowers properly as support measures are extended, and impaired loans should be timely provisioned. The role of transparency in capital markets is crucial in safeguarding their stability. Finally, the report states that further work is needed on *"the risk of harmful cross-border and cross-sector spillovers, including possible feedback loops, and options to mitigate the risk"*.

2. Risk Dashboard

According to the ESRB's latest risk dashboard, published on 6 April, market based indicators of systemic stress have "*mostly recovered*" following the 2020 COVID-19 shock, and "*continued to decline through end-February, falling slightly below its pre-pandemic levels in some markets*" (see Figure 1). While the ESRB acknowledges an improved growth outlook, it notes that the **recovery remains fragile and that risks remain tilted to the downside**. This favourable growth outlook, coupled with expanding credit to the non-financial sector, suggests that Member States might be facing an increase in credit-to-GDP ratios.

The ESRB notes that the annual growth of loans (year-on-year, yoy) to households declined in the majority of Member States, while annual growth rates of loans to NFCs increased in most countries in Q4, 2020 (quarter-on-quarter, qoq). More generally, the IMF notes that globally, the over-indebtedness of NFCs resulting from the pandemic in combination with poor revenue prospects and dependence on policy support might destabilise the financial system. This concern holds especially for small and medium-sized enterprises since access to credit is more challenging for them, resulting in higher liquidity and solvency stress (see also section 3). As of January 2021, the cost of borrowing for households declined slightly in most Member States (yoy), while the results for NFCs are more mixed. Moreover, the ESRB notes *that "credit standards for loans to households for house purchases tightened to some extent across EU Member States in the first quarter of 2021, as did standards for loans to NFCs in a majority of countries*". Option-adjusted spreads on euro corporate bonds are also further continuing on their longer-term downward trend, which started in Q2, 2020, while residential property prices continued to rise considerably in all but one EU Member State in Q3, 2020.

Figure 1: Composite indicator of systemic stress (Last observation 5 March)



Sources: Thomson Reuters, ECB and ECB calculations, taken from the ESRB.
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.

EU banks' profitability continued to improve in Q4, 2020 as compared to the previous quarter, with increased median returns on equity and assets, and a decrease in both the median cost-to-income and net interest income-to-total operating income ratio. A year on year comparison, however, shows the **subdued** nature of **profitability in the banking sector**, with the median return on equity 3.78% for Q4, 2020 as compared to 5.8% in Q4, 2019. This was accompanied by marginal improvements in capitalisation and NPL ratios: the median ratio of CET1 capital to risk-weighted assets increased to 16.9% in Q4, 2020 (from 16.7% in Q3, 2020) while the median ratio of NPLs to total gross loans and advances declined to 2.3% (from 2.5% in Q2, 2020).

In its April 2021 Global Financial Stability Report (GFSR), the IMF warns that unprecedented policy support has enabled extremely easy financial conditions globally, including in the euro area, and *"may result in overly stretched valuations and fuel financial vulnerabilities that, if left unchecked, could put growth at risk."* Buoyant financial markets have contributed to a continuing rebound in prices of risk assets; prices in equity markets have reached levels significantly higher than those derived by fundamentals-based models, warning of **potentially excessive risk-taking and stretched valuations**.

Concerning the banking system's resilience, the IMF's warns of **potentially inadequate credit support for growth once policy support is withdrawn**, especially in countries where banks experienced profitability challenges even before the crisis. Once moratoria expire, higher defaults on existing loans can be expected, which would *"require banks to increase provisions and apply higher risk weights on new nonguaranteed loans."* In the euro area, loans under moratorium amounted to EUR 600 billion, or more than 3% of total loans as of Q3, 2020, indicating that loan-loss reserves might need to be raised to absorb the phase-out of repayment moratoria.

In the **insurance sector**, the median solvency ratio increased by 7 percentage points to 208% in Q3, 2020 (qoq), despite interest rates remaining low. Following a "severe decline" in the value of assets held by insurers in Q1, 2020, total assets have rebounded somewhat, but remain below Q1, 2019 levels. The ESRB also notes that looking at the spread of gross premiums written, it can be concluded that "*the pandemic has had a greater impact on life insurance than on non-life insurance*". Lastly, EU insurers' asset allocation remained stable, and largely at investment grade quality.

Regarding central counterparties (CCPs), the ESRB finds that the "*overall picture drawn from the indicators up to the third quarter of 2020 suggests that CCPs have been resilient to the effects of the COVID-19 pandemic. While variation between individual CCPs is visible, the data continues to show stable trends*".

3. Risk of corporate insolvencies

On 28 April, the ESRB published its analysis concerning corporate insolvencies, highlighting that "*More than a year of restrictions on economic activity has so far not resulted in financial instability. However, the threat of a wave of insolvencies looms large, unless Member States manage a smooth transition from liquidity support towards more targeted solvency support and successful corporate debt restructuring for viable firms.*"

In the same way, the ECB points out in its latest Financial Stability Review, "*Policy measures aimed at supporting corporates and the economy through the coronavirus pandemic may have supported not just otherwise viable firms, but also unprofitable but still operating firms – often referred to as "zombies"[[3] [4]] ... It is argued that such firms* ***weigh on economic productivity by trapping resources and crowding out the emergence of new****, more productive companies. Furthermore, the* ***incentives for some banks to repeatedly extend or alter loan terms*** *so as to avoid writing off their loans (forbearance) can also* ***weigh on bank balance sheets*** *over time, dampening banks' profitability and capacity for new lending ... [also,] the economic impact of the pandemic and the policy response may have, at least temporarily, contributed to some degree of zombification*" (own emphasis).

[3] The ECB is building on the approach of Storz et al., and define zombie firms as those firms that meet all of the following three criteria over two consecutive years: (i) negative returns on assets (net income over total assets), identifying unprofitable firms; (ii) low debt servicing capacity (earnings before interest, taxes, depreciation and amortisation (EBITDA) over financial debt of below 5%), capturing indebted firms; and (iii) negative net investment (annual change in total fixed assets), to avoid capturing young firms.
[4] The ECB refers to several academic studies that estimate that the share of "zombie" firms ranged from 3.4% to 15% before the pandemic (based on different methodologies and "zombie" firm identification definitions), however all the academic studies quoted concur that this share has increased lately.

Adding to a "zombification" issue, the ESRB in the above mentioned analysis also raises concerns over *"a major wave of insolvencies [that] may yet happen if crisis management measures are withdrawn too quickly, and the macro-financial amplification dynamics of a "normal" recession may yet set in"* (e.g. increasing NPL levels, strengthening contingent liabilities, etc.). The ESRB analysis quotes some private sector research sources, which estimate a rise in insolvency levels in 2021[5] by approximately one third as compared to 2019 (see Section 1 for a broader discussion on pass through mechanism).

Box 1: Banks' usability of capital buffers

The IMF GFSR also touches on the issue of capital buffer usability, a topic previously addressed by the ECB in its October 2020 Macroprudential Bulletin. Looking at a sample of 72 banks representing approximately 60% of the global banking system's aggregate market capitalisation, the IMF analysed their capacity to clear three hurdles to drawing down buffers: the capacity hurdle, meaning that using the buffers is possible and safe; the supervisory hurdle, related to the capacity to rebuild buffers in a timeframe so as not to trigger supervisory pressures; and the management hurdle, whereby using the buffers provide higher returns than not doing so.

The results indicate that **only 5% of the sample banks clear the three hurdles**, with the management hurdle binding for most banks. The IMF finds that *"Profitability is the single most important factor that enables a bank to clear the supervisory and management hurdles. Credit quality of new loans, bank leverage, and dividend payments also play important roles"*, and *''that most banks have insufficient economic incentives to draw down their buffers if they are (or expect to be) asked to rebuild them later.''* These low incentives to using the buffers poses a potential risk for the recovery since banks should be able and willing to lend to the economy once government support ends in order to minimise scarring effects of the crisis. However, as noted by the Chair of the Basel Committee on Banking Supervision in an April 2021 speech, *"if the pandemic continues to unfold and escalate, ultimately affecting the solvency of borrowers, banks will have lower buffers against future shocks that may increase future vulnerabilities. Policymakers and supervisors should be mindful of such trade-offs when considering the use of bank capital buffers, including the optimal pace of rebuilding these buffers, and may use stress-test results to reassess forward-looking bank capital plans"*.

The Financial Stability Board is also expected to present an interim report in July 2020 on financial institutions' use of capital and liquidity buffers and how well crisis management and operational resilience arrangements have functioned in the COVID-19 crisis

For an overview of a set of ECON-Commissioned papers on this topic, see also here.

The ESRB suggests *"**four lines of defence** that policymakers can use to mitigate the destabilising impact of corporate insolvencies and to support a swift and sustainable economic recovery:*

1. emergency liquidity support schemes during lockdowns (system-wide);
2. solvency support schemes to compensate for losses (more targeted, e.g. sector-wide);
3. debt restructuring and/or equity injections to repair balance sheets of companies with viable business models (individual companies);
4. efficient insolvency procedures to ensure that non-viable firms are swiftly wound down and resources can be reallocated to productive uses (individual companies)".

Regarding the latter, the ESRB Advisory Scientific Committee (ASC) published its Insight addressing possible policy options to follow, in order to mitigate the risks discussed above: (i) targeting firms that are more likely to be viable when considering support interventions; (ii) address issues that are likely to be key, such as *"the potential congestion of the insolvency system, the inadequacy of existing formal restructuring procedures for*

[5] According to Allianz Research and Euler Hermes *"in 2021 there could be a rise in insolvencies of about 32% in western Europe and 34% in central and eastern Europe from 2019 levels, following the gradual ending and phasing out of fiscal support measures"*.

most SMEs, the incentives of the relevant parties to restructure as opposed to liquidate, and the provision of liquidity during restructuring"; (iii) strengthen the incentives for banks' loan restructuring; while also taking into account (iv) related congestions in capital and labour markets as well as administrative and legal cost burden related to bankruptcy procedures.

Over the long-term, the ESRB ASC advocates that EU insolvency law *"could generate considerable gains in the ability to handle future adverse shocks"*, if reforms would be made regarding improvement of in-court insolvency procedures, facilitating in-court restructuring (as opposed to liquidation), reducing reliance on timing for driving liquidation decisions, separating of small-firm and large-firm insolvency procedures and overall, aiming for more uniform EU insolvency system. One should note that (a certain degree of) harmonisation in national insolvency regimes has been highlighted for some time now as a bottleneck in the EU crisis management regime. Several initiatives are being taken, notably discussions at the level of Eurogroup and Ecofin and external studies (see here and here).

4. Low interest rates environment and macroprudential policy

In late 2019, the ESRB General Board mandated the Joint Task Force of the ESRB Advisory Technical Committee, Advisory Scientific Committee and Financial Stability Committee to revisit the 2016 report on macroprudential policy issues arising from low interest rates and structural changes in the EU financial system. The Joint Task Force was asked to assess subsequent developments, identify new areas of risk and to propose mitigating macroprudential actions. The outcome of this review was endorsed by the ESRB General Board and published on 1 June 2021. The report focuses on the EU financial system as a whole, with a medium term time horizon.

The updated report finds that the low interest rate environment has been mainly driven by structural factors, not just unique to the euro area (such as demographics, productivity, excess savings and low investment). The report explores the ways in which, changing longer-term market expectations (namely, the so called flattening of the yield curve), COVID-19 could have a positive or negative impact on rates, and noting that it "*may increase the probability and persistence of the "lower for longer" scenario, transforming it into an "even lower for even longer" scenario"*.

Looking at the evolution of risks since 2016, the report identifies four areas of concern owing to the low interest rate environment, and a number of policy options aimed at mitigating these risks. First is the **profitability and resilience of banks**, whereby low interest rates are accentuating existing structural problems in the EU banking sector related to overbanking and low profitability. Policy options suggested include addressing overcapacity by removing potential obstacles to banking sector consolidation and restructuring; reconsidering the framework for dealing with weak banks; re-evaluating incentives for banks' digital transformation and improving cost efficiency; and assessing legal restrictions on the application of negative interest rates to deposits.

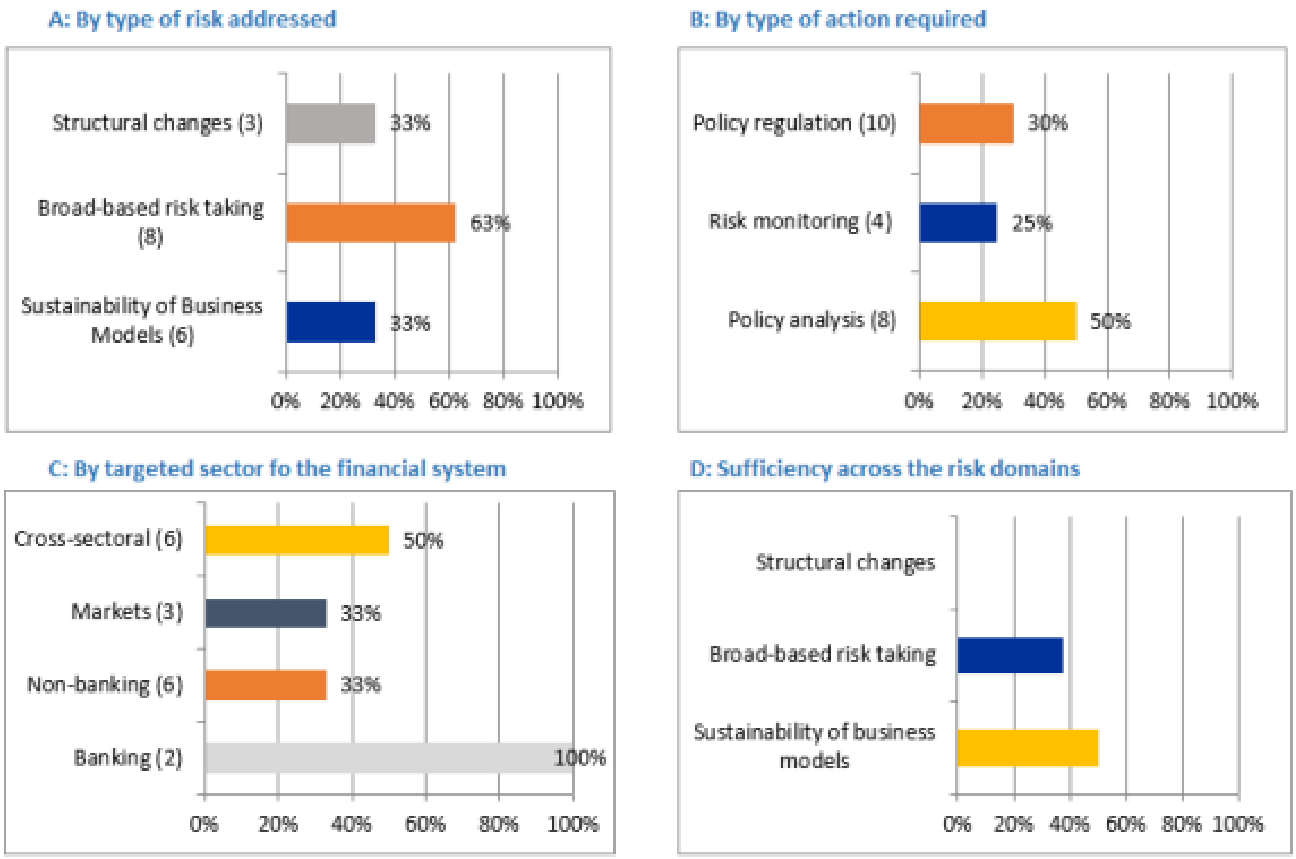
The second area of concern is the **indebtedness and viability of borrowers**, as low interest rates facilitate higher leverage and an intensified search for yields. The ESRB suggests developing macroprudential measures to prevent and resolve high levels of corporate indebtedness and developing a common minimum toolkit of borrower-based measures targeted at households as possible policy responses.

Third, is **systemic liquidity risk**, whereby the financial system is more sensitive to market shocks, as evidenced in March 2020. Here, moving towards macroprudential liquidity requirements could mitigate such risks.

Lastly, the **sustainability of the business models of insurers and pension funds** offering longer-term return guarantees, as they come under increasing pressure in a low interest rate environment is considered as an area of concern. Possible policy responses are described as: including macroprudential measures for the insurance sector in the Solvency II review and in particular, the ESRB should support EIOPA's Opinion issued as part of the review of the Solvency II Directive, in line with the views expressed in the ESRB report on macroprudential policy for the insurance sector; establishing a recovery and resolution framework for insurance companies; considering issues and policy proposals raised in this and the 2016 report for pension funds in the Institutions for Occupational Retirement Provision (IORP) II review.

In the 2016 report, the ESRB presented 17 policy options, addressing risks to the sustainability of business models, broad-based risk taking, and changes to the structure of the financial system. Since these were not ESRB recommendations, implementation was not enforced. Overall, the ESRB finds that none of these recommendations have been fully implemented.

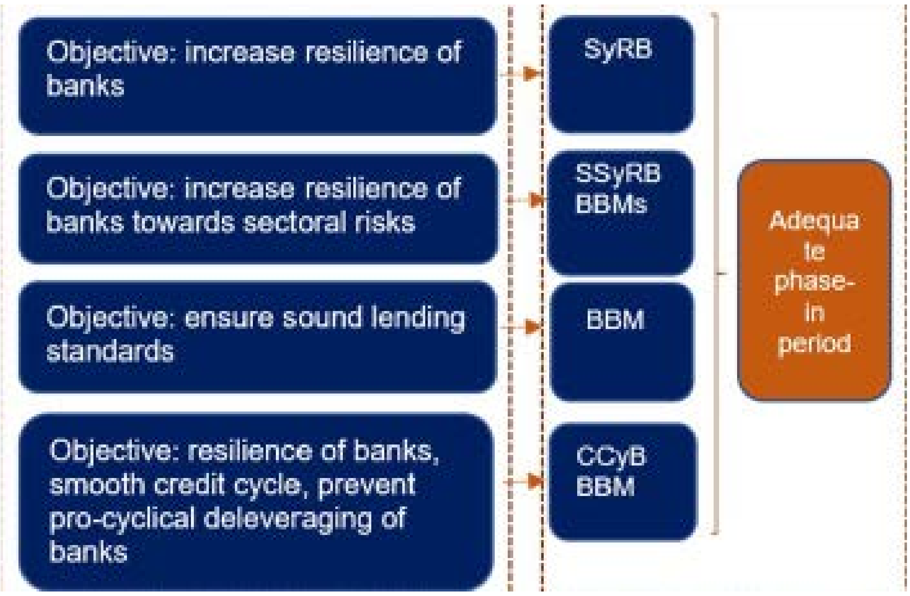
Figure 2: Progress of policy implementation



Source: *ESRB*.
Note: Panels A, B and C present the share of implemented or partly implemented policies. Panel D illustrates the share of policies whose implementation is considered sufficient. The ESRB does not weight proposals according to their relevance.

The ESRB further notes that "*macroprudential tools available to address the financial stability risks stemming from the [low interest rate environment] are limited to banking sector and borrower-based measures for households based on national legislation*". Policy responses therefore need to encompass more than just macroprudential policy. Moreover, the ESRB finds that "*a move from traditional banking activities and related risks to non-bank financial intermediation* ***requires the development of macroprudential policy beyond banking and more activity-based regulation in addition to the current entity-based regulation***" (see Section 5). Looking at the existing toolkit however, the report remarks that "*no EU Member State has explicitly used macroprudential instruments motivated by systemic risks related to the [low interest rate environment]*". However, the existing macroprudential tools that could address such systemic risks can be summarised as per Figure 3:

Figure 3: Existing macroprudential tools for addressing systemic risks related to the low interest rate environment



Source: ESRB.

In an October 2020 Macroprudential Bulletin article, the authors concluded that "*The prevailing "lower for longer" interest rate environment reinforces the case for building up releasable bank capital buffers in good times to be consumed when a crisis hits, thereby lowering the point where dividend restrictions would be triggered.*" Using counterfactual simulations in the context of the COVID-19 crisis, their analysis finds that a more sizable pre-crisis build-up of countercyclical buffers (CCyB) would have enhanced the crisis policy response, especially in a low interest rate environment.

5. Macroprudential policy concerns beyond banking

The ESRB is mandated to oversee broad macroprudential risks that may arise in the financial system as a whole (see EGOV briefing for the specific features of ESRB mandate). Even if particularly focused on the banking sector, the ESRB has been attentive to other financial sectors as well (see previous sections and list of recommendations issued thus far).

According to a recent ECB bulletin, over the past decade, the prominence of money market funds (MMFs) and investment funds has significantly increased, with the total value of the latter sector assets more than doubling and reaching € 15.5 trillion in mid-2020. The sector *"provide(s) a range of services to the financial system and the wider economy, such as diversified portfolio investment, cash management and funding"*. As MMFs and investment funds play a different role in the financial system, the ECB has provided some policy recommendations in its April 2021 macroprudential bulletin for further developments of macroprudential policy for those sectors.

Following the pandemic outbreak in March 2020, a number of European MMFs and other open ended investment funds that have invested in illiquid assets experienced severe liquidity issues, which exposed the structural vulnerabilities caused by liquidity mismatches, compromising the ability to absorb shocks. Outflows prompt funds to engage in procyclical behaviour, as they revert to fire sales that increase pressure on market liquidity and asset valuation. Additionally, given the fact that MMFs act as a credit provider to the financial system (as well as an important cash-like asset for investors), when the crisis shock hit the market, the MMFs acted procyclically, contributing to the decline of market liquidity and further amplifying the shock.

As a response to the crisis, some open ended investment funds have suspended redemptions, which, as the analysis published by the ECB reveals, have had *"spillover effects on other funds within the same asset management company and other asset classes as well"*. As the ECB highlighted, *"suspending redemptions can mitigate stress at the fund level, but it impairs investors' ability to raise liquidity ... and can result in a decline in confidence and reputational losses"*.

According to the ECB analysis, the **macroprudential regulatory framework is not capable to sufficiently address risks stemming from liquidity mismatches in investment funds and is absent for MMF sector**. As the ECB notes, the March 2020 turmoil required "*extraordinary central bank intervention by the ECB and other authorities globally*". It also concludes that *"**structural vulnerabilities** in the investment fund sector **should be addressed by establishing a comprehensive macroprudential framework**"* (own emphasis).

Acknowledging the systemic risks related to the investment funds, the ESRB in May 2020 has issued two recommendations on liquidity risks arising from margin calls and on liquidity risks in investment funds. Also, the ESRB General Board discussed in its 25 March meeting risks arising from MMFs and the impacts of March 2020 turmoil events. The General Board "*will further consider a range of issues, including the wider markets in which MMFs operate, the behaviour and expectations of investors in MMFs, as well as the structure of MMFs and the liquidity management tools available to them, with a view to adopting a Recommendation by the end of 2021. An ESRB note summarising the initial considerations in this regard will be published in the spring*".

Following up on work being done at international level and concerns around systemic risk arising from the asset management side[6], ESMA has also recently published a number of papers addressing MMFs (see EGOV briefing). Also, as of 26 June 2021, in line with the new regulation, largest and the most systemic investment firms will be classified as credit institutions, therefore as a result, they will have to obtain banking license and be supervised accordingly (in most of the cases, the ECB Single Supervisory Mechanism will take over their direct supervision). According to the ECB, *"These new rules are intended to better reflect the actual risks taken by the different types of investment firms and to make the supervision of such firms more effective"*.

6. Recent ESRB Recommendations

On 15 December 2020, the ESRB issued an amending Recommendation following the Recommendation ESRB/2020/07 regarding restriction of distributions during the COVID-19 pandemic (ESRB/2020/15). The new Recommendation extends the restrictions imposed on financial institutions[7], which *"aimed to ensure that all financial institutions that may pose a risk to financial stability maintain high levels of capital by asking relevant authorities to request financial institutions to refrain from making distributions for the duration of the COVID-19 pandemic."* More precisely, the ESRB extended its Recommendation for financial institutions to refrain from the following actions until 30 September 2021: *"(a) make a dividend distribution or give an irrevocable commitment to make a dividend distribution; (b) buy-back ordinary shares; (c) create an obligation to pay variable remuneration to a material risk taker."* The Recommendation is applied *"at the EU group level (or at the individual level where the financial institution is not part of an EU group), and, where appropriate, at the sub-consolidated or individual level."* In contrast with the initial Recommendation ESRB/2020/07, the amended one concludes that there is no longer necessary to cover CCPs within its scope. According to the future macroeconomic outlook and new information on the financial system's stability, the General Board

[6] ESMA, issued in December 2020 guidelines on the use of leverage by alternative investment funds with the aim of ensuring that competent authorities adopt a consistent approach when assessing whether the condition for imposing leverage-related measures are met. These are a response to an ESRB recommendation (ESRB/2017/6). ESMA signalled on 8 April 2021 that the alternative investment funds sector suffered strong impacts from the COVID crisis and that liquidity risks are still relevant (being the "*mismatch between the potential liquidity of the assets, and the redemption timeframe offered to investors*" particularly highlighted).

[7] The initial Recommendation, recommended to restrict distributions at least until 1 January 2021.

of the ESRB will decide whether the Recommendation needs to be amended further or not before its expiring date of 30 September 2021.

Moreover, on 8 December 2020, the ESRB issued a Recommendation regarding Norwegian notification of its intention to set a systemic risk buffer rate (SyRB) in accordance with Article 133 of Directive (EU) 2013/36/EU (ESRB/2020/14). The SyRB rate applies to the domestic exposures of all credit institutions authorised in Norway, including the five subsidiaries of parents established in other Member States. It was applied from 31 December 2020, and for institutions not using the advanced internal ratings-based approach, it is expected to be set at 3% until 31 December 2022 and at 4.5% afterwards. In this regard, the ESRB recommended that *"the proposed SyRB rate notified under Article 133(11) of Directive 2013/36/EU is considered justified, suitable, proportionate, effective and efficient for the risk Finansdepartementet is targeting"*.

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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 amending Recommendation ESRB/2015/2 for Luxembourg on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2021/2)

Recommendation amending Recommendation ESRB/2015/2 for Norway on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2021/3)

Recommendation amending Recommendation ESRB/2020/07 on restriction of distributions during the COVID-19 pandemic (ESRB/2020/15)

Recommendation regarding Norwegian notification of its intention to set a systemic risk buffer rate (ESRB/2020/14)

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/2019/3 amending the ESRB/2016/14)