Mario Draghi: Building on the achievements of post-crisis reforms

Speech by Mr Mario Draghi, President of the European Central Bank and Chair of the European Systemic Risk Board, at the second annual conference of the ESRB, Frankfurt am Main, 21 September 2017.

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It is my pleasure to welcome you to the second annual conference of the European Systemic Risk Board (ESRB).

The conference coincides with the tenth anniversary of the start of the global financial crisis in the summer of 2007. The crisis shook the European Union to the core, and required substantial policy actions to stabilise the economy and the financial system. With a return to stability having been achieved, it is important that we take time to reflect on what we have learnt, what we have achieved over the past ten years, and where we need to do further work.

The crisis taught us that individual banks and the banking system as a whole needed to be more resilient than they were pre-crisis. As a result, many reforms have been put in place in recent years. Our banking regulation and supervision have become stricter. Moreover, the European regulatory framework now places greater emphasis on identifying and addressing system-wide risks. This includes the establishment of the ESRB and the creation of macroprudential instruments assigned to public authorities.

A more resilient post-crisis banking sector

In the banking sector, significant efforts have been made in recent years to increase resilience. In the euro area, for example, the average Common Equity Tier 1 ratio of significant institutions rose from 7% in 2008 to 13.5% by end-2016. And banks are required to set up solid governance structures and prudent risk management practices. Moreover, resilience is now tested more rigorously in a forward-looking manner. The EU-wide stress tests coordinated by the European Banking Authority (EBA) have become an important tool for quantifying banks' capital needs, with a view to ensuring that they would be able to continue lending to creditworthy borrowers even during a severe recession.[1], [2]

Post-crisis prudential rules have also provided public authorities with macroprudential tools to address systemic risks in the banking sector.[3] And the understanding of how to calibrate and implement these tools has advanced. For example, all Member States now have a countercyclical capital buffer framework that is fully operational.[4] Four Member States have announced a non-zero buffer rate for domestic exposures.

Yet despite these steps forward, it is important to remain vigilant. One important aspect concerns the interaction between monetary policy and macroprudential policies.[5] Financial and business cycles can potentially become de-synchronised, meaning that financial imbalances can grow in an environment characterised by relatively muted inflation. In such an environment, the use of monetary policy is not the right instrument to address financial imbalances, and may lead to substantial deviations of aggregate output and inflation from their desirable levels. This is particularly so in a currency union where monetary policy affects the entire region, but financial imbalances may be local in nature. Macroprudential policies, targeted at particular markets or countries, can play a key role in addressing such imbalances.

Indeed, the ESRB last year identified medium-term vulnerabilities in some countries' residential real estate sectors – precisely the type of situation that macroprudential policies are designed to address. It published country-specific warnings to eight Member States in November 2016, in accordance with its mandate to identify and flag significant systemic risks.[6]

But beyond increasing the resilience of the banking sector, there is also a need to address the remaining legacies of the crisis. Two important aspects are the *resolution*of already impaired assets, and better *accounting* for impaired assets for the future.

Despite recent progress, the level of non-performing loans (NPLs) on European banks' balance sheets remains high.[7] At the end of 2016, the stock of gross NPLs in the EU banking sector was around €1 trillion. This number, however, does not take into account the fact that that collateralised lending plays an important role in Europe. For example, including collateral and provisioning, the coverage of NPLs is, on average, 82% in the euro area. Banks' profitability, however, is affected by the lower returns provided by the NPLs, given the weight of gross exposures in total assets: gross NPLs represent 4% of the total assets of euro area banks, against only 0.8% for US banks.[8]

The outstanding stock of NPLs is a consequence of cyclical and structural factors. First, the severe recession resulting from the global financial crisis led to a deterioration of the quality of banks' loan books. The current economic expansion should therefore help to improve the asset quality of European banks. At the same time, structural weaknesses still persist. These include inadequate internal governance structures in banks, ineffective and costly debt recovery procedures in some Member States and misaligned incentives that prevent a quick resolution of NPLs. To this end, the ESRB has proposed[9] a series of measures to complement those already being taken at EU and euro area level.[10]

In the short term, the ESRB's proposals focus on strengthening banks' NPL management, including their prudent measurement and the valuation of the associated collateral. Policymakers could aid this process by developing blueprints for asset management companies, accompanied by harmonised data templates across the EU.

Measures should also concentrate on insolvency regimes, debt recovery and servicing capacities with a view to improving recovery rates from NPLs. Over a longer horizon, secondary markets' trading platforms should be further developed. And banks also need to be given adequate incentives, in particular in relation to accounting for impaired assets.

From 1 January 2018 onwards, a new accounting standard for the classification and measurement of financial instruments, known as IFRS 9[11], becomes mandatory in EU. At the request of the European Parliament, the ESRB has recently published a report on the financial stability implications of IFRS 9,[12] which concludes that it is a major improvement, particularly regarding accounting for NPLs. The most important change introduced by IFRS 9 is the shift from an incurred loss approach to an expected credit loss approach for measuring impairment allowances. This means that banks will have to recognise impairments earlier, curtailing excessive forbearance towards NPLs and helping ensure that banking sector repair takes place in a timelier and more comprehensive manner in future downturns. A recent impact assessment, based on a sample of 54 banks across 20 Member States published by the European Banking Authority, suggests that the introduction of IFRS 9 would lead to an increase of provisions of about 13% on average.[13]

The expected credit loss approach also means that banks will have to react in their accounting to new and forward-looking information as it is received. This means that impairment allowances may increase suddenly and significantly when economic conditions deteriorate, which could have certain pro-cyclical effects.[14] The ESRB report considers a number of policies that could address such effects.

For example, stress testing could be used as a means to gauge the variation in impairment allowances associated with adverse scenarios, in order to ensure that sufficient capital buffers are in place and to allow for remedial policy action if required. If banks can withstand a hypothetical adverse scenario, they would likely be able to cope with the early recognition of expected credit losses under a real downturn, as required by IFRS 9.

Identifying and addressing risks beyond the banking sector

Given the bank-based nature of the European economy, the state of the banking sector is central to our assessment of systemic risk. But the financial system is constantly evolving. Since 2008, the assets of the non-bank financial sector in the euro area have roughly doubled and are now slightly larger than those of the banking sector.[15] The path to growth set out in the European Commission's Action Plan on Building a Capital Markets Union (CMU) means that the non-bank financial sector is likely to play an increasingly important role in financing the economy.[16] This evolution offers many opportunities: it would provide new sources of funding for business, and it would help increase options for investors and savers.

Yet, as financial intermediation shifts from banks to non-banks, existing risks may migrate and new risks may emerge. It is important, then, to identify such risks and to develop tools to mitigate them.[17]

Take, for example, the issue of interconnectedness between different parts of the financial system. Interconnectedness – be that through direct exposures or indirectly via common or correlated asset holdings – is a natural feature of an integrated financial system. But during times of financial stress, interconnectedness transmits and potentially amplifies shocks, and can lead to contagion. Full visibility is of the essence here.

In this regard, the second EU Shadow Banking Monitor, published by the ESRB earlier this year,[18] analyses a unique data set collected by the EBA. The data show that exposures of EU banks to shadow banking entities amount to over €1 trillion.[19]Focusing on a more granular subset of these exposures, the analysis finds that 60% of EU banks' exposures to shadow banking entities are to entities domiciled outside the EU.[20] These findings highlight the global and cross-border interconnectedness of the banking and shadow banking systems and the need for international cooperation in monitoring and addressing cross-sectoral risks. Unilateral actions and isolated national attempts are predisposed to fail.

When moving from identifying to addressing risks in the financial system, a number of elements need to work in tandem: good regulation and supervision make individual firms safer; recovery and resolution regimes provide legal certainty when a firm gets into trouble and they ensure that failure is orderly; and macroprudential policy looks beyond individual institutions and deploys tools to target systemic risks.

A recovery and resolution regime is particularly important for central counterparties (CCPs), which have become critical hubs in the financial system. Legislation in this area is progressing, and the ESRB continues to identify areas of refinement to better address macroprudential considerations.[21] This includes the need for cooperation and coordination between resolution authorities for banks and CCPs, as distress of a CCP would typically be triggered by distress in one or more banks that are clearing members of the CCP.

Creating a harmonised recovery and resolution framework for the insurance sector across the EU is also important. Ordinary insolvency procedures may not always be consistent with policy holder protection and financial stability objectives. This means that they may not suffice to manage the failure of a large insurer or the simultaneous failure of multiple insurers in an orderly fashion. For example, Romania developed a comprehensive recovery and resolution framework of this kind following difficulties faced by two large insurers in 2014 and 2015. And the Netherlands and France are in the process of developing such frameworks after experiencing the near-failure of some financial conglomerates during the global financial crisis.[22]

Addressing systemic risks requires macroprudential tools that public authorities can use.

Reflecting this, the ESRB recently noted that there is a need to establish a comprehensive macroprudential toolkit beyond banking, which to date is lacking.[23] Of course, specific tools still need to be developed. The ESRB has done preliminary work assessing what those tools might be. One example is the macroprudential use of margins and haircuts, on which I updated the European Parliament earlier this year.[24], [25]

Conclusion

Let me conclude.

Much has been achieved since the global financial crisis. In particular, banks in Europe are more resilient and the banking union has advanced. Moreover, authorities have the mandates and tools to tackle risks in the banking sector and are using them. These improvements have created a financial system that poses fewer risks to the real economy.

At the same time, work remains to be done. Authorities need to watch out for blind spots, where risks can build up unnoticed, and use the tools at their disposal. And legislators need to be mindful that authorities require a broad range of tools to be able to tackle risks beyond the banking sector.

I hope that when you return to your institutions, this conference will have strengthened your resolve to address the challenges in banking and beyond that are discussed here. On that note, I am pleased to open this second annual conference of the European Systemic Risk Board.

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1 For example, the most recent stress tests by the European Banking Authority in 2016 included 51 banks from 15 EU and EEA countries, covering around 70% of banking assets in each jurisdiction and across the EU. See European Banking Authority (2016), “2016 EU-wide stress test results”, July.

2 The ESRB has contributed a macroprudential perspective to these stress tests and developed surveys to consider feedback loops. See, for example, ESRB (2016a), “Adverse macro-financial scenario for the EBA 2016 EU-wide bank stress testing exercise”, March; and Brinkhoff, J., S. Langfield, and O. Weeken (2017). “From the horse’s mouth: surveying responses to stress by banks and insurers”, ESRB Occasional Paper, forthcoming.

3 i.e. the Capital Requirements Directive IV and the Capital Requirements Regulation.

4 ESRB (2017), “A Review of Macroprudential Policy in the EU in 2016”, April.

5 “The interaction between monetary policy and financial stability in the euro area”, keynote speech by M. Draghi at the First Conference on Financial Stability organised by the Banco de España and Centro de Estudios Monetarios y Financieros, 24 May 2017.

6 For details, see the special feature on assessing vulnerabilities and policy stances in the residential real estate sector in ESRB (2017), “A Review of Macroprudential Policy in the EU in 2016”, April.

7 See, for example, Constâncio, V. (2017), “Resolving Europe’s NPL burden: challenges and benefits”, February.

8 See, Constâncio, V. (2017), “Challenges faced by the European banking sector”, June.

9 See ESRB (2017), “Resolving non-performing loans in Europe”, July. The ESRB policy proposals should not be understood as formal ESRB warnings or recommendations, as defined by Article 16 of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (OJ L 331, 15.12.2010, p. 1.

10 See, for example, ECB Banking Supervision (2017), “Guidance to banks on non-performing loans”, March.

11 International Financial Reporting Standard 9.

12 ESRB (2017), “Financial stability implications of IFRS 9”, July 2017.

[13] EBA (2017), “Report on results from the second EBA Impact Assessment of IFRS 9”, July.

[14] For a model-based assessment, see Abad, J. and Suarez, J. (2017), “Assessing the cyclical implications of IFRS 9 – a recursive model”, ESRB Occasional Paper, No 12.

[15] European Central Bank (2016), “Report on financial structures”, October.

[16] European Commission (2015), “Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – Action Plan on Building a Capital Markets Union”, September.

[17] Speech by M. Draghi at the first annual conference of the ESRB, Frankfurt am Main, 22 September 2016.

[18] ESRB (2017), “EU Shadow Banking Monitor”, May.

[19] Abad, J., D’Errico, M., Killeen, N., Luz, V., Peltonen, T., Portes, R. and Urbano, T., “Mapping the interconnectedness between EU banks and shadow banking entities”, ESRB Working Paper No 40, 2017.

[20] This analysis focuses on exposures to shadow banking entities that are equal to or above 0.25% of each institution’s eligible capital.

[21] ESRB (2017), “Opinion on a central counterparty recovery and resolution framework”, July.

[22] ESRB (2017), “Recovery and resolution for the EU insurance sector: a macroprudential perspective”, August.

[23] ESRB (2016), “ESRB response to the European Commission’s Consultation Document on the Review of the EU Macro-prudential Policy Framework”, October.

[24] Introductory statement by M. Draghi at the Hearing before the Committee on Economic and Monetary Affairs of the European Parliament, May 2017.

[25] ESRB (2017), “The macroprudential use of margins and haircuts”, February.