Luis de Guindos: Macroprudential policy ten years after the crisis

Keynote speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the CIRSF Annual International Conference 2019 "Financial Supervision and Financial Stability Ten Years after the Crisis: Achievements and Next Steps", Lisbon, 4 July 2019.

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Since the financial crisis, the euro area's institutional architecture has evolved significantly. Back in 2010, in the midst of the crisis, we created the predecessor of today's European Stability Mechanism (ESM) to provide assistance to euro area countries experiencing or threatened by severe financing problems.[1]

At the same time, the European System of Financial Supervision was introduced, aimed at ensuring consistency and appropriate financial supervision in the EU. It includes the European Banking Authority (EBA), which provides harmonised prudential rules for financial institutions in the EU, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority. Since 2010, the European Systemic Risk Board (ESRB) brings these institutions together with the national supervisory authorities and central banks to share their assessments on the financial system and devise consistent supervisory responses for the entire EU.

Since the establishment of the Single Supervisory Mechanism in 2014, the ECB is the European banking supervisor and closely cooperates with the three European Supervisory Authorities, and especially with the EBA. Should banks fail, the Single Resolution Board ensures their orderly resolution with as little impact as possible on the real economy and public finances thanks also to the funds available from the Single Resolution Fund. Only last month, the Eurogroup agreed to equip the Single Resolution Fund with a backstop financed by the ESM to further strengthen the European financial architecture.[2]

Looking beyond microprudential supervision, we have built up the macroprudential policy toolkit over the past ten years, to address risks of a systemic nature. National authorities and the ECB can deploy pre-emptive macroprudential tools to mitigate risk-taking and enhance the resilience of the financial system, while the ESRB can issue warnings and recommendations.

In my remarks today, I will discuss the financial stability challenges facing the euro area and will focus on the relevance of countercyclical macroprudential policy to safeguarding financial stability and supporting prudent lending, by banks and non-banks, throughout the cycle. So far, macroprudential policies have focused on the banking sector. But the financial system is broader than that. Non-bank financial entities such as investment funds, insurance companies and pension funds also take on risks and can amplify the wider financial cycle. So it is more important than ever that macroprudential policies are broadened to cover these non-bank financial entities as well.

Financial stability and macroprudential policy in the Economic and Monetary Union

The euro area's ongoing economic recovery faces renewed global headwinds that are weighing on the economic outlook. Uncertainties related to the rising threat of trade protectionism, vulnerabilities in emerging markets and geopolitical factors, including those related to Brexit, make the economic environment more challenging.[3]

In this environment, the ECB's accommodative monetary policy is necessary for inflation to remain on a sustained path towards levels that are below, but close to, 2% over the medium term.[4] At the same time, the environment indicates that risks to economic growth are tilted to the downside.

This reinforces the need to strengthen the balance sheets of our financial and non-financial firms to withstand any shocks that may occur. Fortunately, banks have done exactly that over the last decade. Capital ratios of euro area systemic banks increased from 10.4% at the end of 2010 to 14.3% by the end of last year (in terms of common equity tier 1). This increase has been facilitated by the general recovery, supported by the ECB's accommodative monetary policy, and is a reaction to increased market pressures and additional macroprudential requirements.

Indeed, macroprudential policy aims to maintain a strong and stable financial system. It has become a crucial complement to the ECB's monetary policy which is geared towards achieving price stability. While the current accommodative monetary policy is supporting the economic recovery, it may generate undesired side effects in the form of excessive risk-taking. Macroprudential policy can counter these excesses with its targeted toolkit. By imposing additional requirements, it can restrain lending to excessively risky borrowers or create the necessary loss absorption capacity in specific sectors or countries.

Institutional set-up of macroprudential policy within European banking supervision

This more targeted application of macroprudential policy to individual countries is also reflected in its institutional set-up. National authorities are first in line to counter emerging systemic risk in a timely manner by deploying the available instruments. They have detailed knowledge of their domestic banking systems and financial structures. The ECB, in turn, complements the national authorities with its cross-country perspective. It can identify regulatory differences and counter potential inaction bias by the national authorities. To operate this two-tier set-up effectively, the SSM Regulation provides that national authorities must notify the ECB of macroprudential measures they intend to implement. The ECB's Governing Council may object to these measures and, if deemed necessary, set higher macroprudential requirements than those set by national authorities, commonly known as "top-up".[5]

The "top-up" option is considered a last resort. There are two main reasons for this. First, national authorities being responsible for addressing financial imbalances creates a clear expectation that they do so in a timely manner. If national macroprudential authorities can act with a complete macroprudential toolkit to fulfil their mandates, the scope for the ECB to set higher requirements is more focussed to address risks from cross-country spillovers to secure a consistent application across countries. Second, macroprudential policy authorities, represented by national central banks and supervisors, come together at the ECB's Financial Stability Committee (FSC). The FSC serves as the central platform of exchange at the technical level for authorities to share their experience in financial stability and macroprudential policy. The Committee has achieved important milestones in increasing data coverage and quality, assessing systemic risk and developing calibration strategies for macroprudential instruments.

This holds also true for those instruments that are not fully harmonised at EU level. For example, borrower-based measures such as loan-to-value, loan-to-income or debt service-to-income can limit the leverage of households and non-financial corporations. These instruments are thought to be the most effective macroprudential instruments for curtailing excessively risky credit origination. Indeed, because of their effectiveness, 13 countries have already implemented measures targeting the specificities of their real estate markets.

Nevertheless, some euro area countries do not have the full legislation in place to deploy all borrower-based measures.[6] And even if they do, the institution that decides on borrower-based instruments is not always the central bank or the supervisory authority. This creates an additional hurdle to deploying the best macroprudential policy responses. As a result, some macroprudential authorities use recommendations to the financial institutions as a second-best option.

Beyond the possibility of using borrower-based measures to address real estate risks, Belgium and Finland have increased the risk weights on banks' mortgage exposures.[7] These measures focus on banks' resilience to potential losses on their outstanding stock of mortgage loans.

Systemic risks may also arise from sources other than real estate. Therefore, national authorities have increased the combined buffer requirements, which include five different buffer types.[8] First, the capital conservation buffer of 2.5% is applied to all banks to maintain capital in the banking system.[9] Second, to mitigate the "too-big-to-fail" problem, the buffer for global systemically important institutions is currently applied, in the range of 1-2%, to eight globally important banks in France, Germany, Italy, the Netherlands and Spain. Third, buffers of up to 2% have been applied to more than 100 other (or domestic) systemically important institutions across the euro area. Fourth, four countries are addressing structural risks by applying the systemic risk buffer either to individual institutions, in the case of Austria, the Netherlands and Slovakia, or at the country level in the case of Estonia.

The fifth buffer is the countercyclical capital buffer (CCyB). It is central to a countercyclical macroprudential policy as it helps ensure financial stability throughout the cycle. By raising capital requirements as imbalances are building up, it increases bank resilience well ahead of potential shocks. In a downturn, the CCyB can be released to give banks the necessary capital space to support lending to the real economy.[10] So far, seven euro area countries have announced that they will activate or increase CCyB rates of up to 1.5%.[11]

The ECB's view is that banks' overall capital levels are currently appropriate. Nevertheless, the current buffer calibrations prevent them from being used countercyclically throughout the cycle. The limited size of the CCyB calibrations restricts the possibility for releasing it to support lending to the real economy if the cycle turns. As macroprudential authorities, we are therefore continuing to review the implementation and scope of the available instruments. In this respect, we very much welcome last month's publication of the new Capital Requirements Directive (CRD V) and Capital Requirements Regulation (CRR II) to strengthen the macroprudential toolkit.[12]

Role of the non-bank financial sector and macroprudential policy

Despite the many achievements in the regulatory reform process since the crisis, there are areas where more work needs to be done. In my view, the regulatory framework for the non-bank financial sector is one of these areas. First of all, the sector has grown significantly in size and importance. Second, it is accumulating ever more risks on its balance sheet. And third, work on the macroprudential framework for this sector is still in its infancy.

Let me start with the growing size of the sector. In the euro area, total assets held by non-banks have almost doubled over the last ten years, growing from €23 trillion in 2008 to €42 trillion in 2018. While the size of the banking sector stagnated over this period, non-banks currently account for around 55% of the euro area financial sector.[13] The fast growth of non-banks reflects their increasing role in financing the euro area real economy. Whereas ten years ago, non-banks accounted for 14% of the euro area financial sector's loans to non-financial corporations, they now account for twice that share. Moreover, non-banks provide a steady net flow of financing to non-financial corporations through the purchase of debt securities. In the ten years prior to the crisis, euro area non-financial corporations obtained only 10% of their credit by issuing debt securities, while this share increased to more than 50% in the decade after the crisis.

By diversifying the financing sources of the real economy, the non-bank financial sector plays an important role in financial intermediation. It provides an additional source of financing and can ultimately help to smooth shocks in the euro area. The growing relevance of non-bank intermediation can, however, create potential new vulnerabilities.

In their search for higher yields, non-banks have accumulated more risks in their investment portfolios in recent years. For instance, more than half of the bonds held by euro area investment funds are BBB-rated or lower. For euro area insurers this share is somewhat smaller, at around 40%, but it has increased by more than 5 percentage points over the last five years. Insurers have also been venturing into alternative asset classes such as alternative, infrastructure and private equity funds, loans and real estate holdings. Their exposure to these assets has reached almost 10% of total investment and is expected to rise further.[14]

As some of these assets are highly illiquid, the portfolio shift towards these assets may also increase insurers' liquidity risk beyond credit risk. But this is only one example, where the credit risk on non-banks' balance sheets is coupled with liquidity risk. In fact, liquidity risk is particularly an issue for some bond and equity funds that invest in less liquid assets, while offering short-term redemptions to their investors. These funds are vulnerable to sudden changes in investor sentiment, so-called "run risks". Some recent cases were a reminder that investors in less liquid funds might indeed run if they fear deterioration in asset quality or liquidity.[15] While recent instances happened in a generally stable market environment and did not have systemic repercussions, liquidity problems might have been larger in an adverse market environment and with many funds affected simultaneously. If anything, the liquidity mismatches observed in bond and equity funds call for greater scrutiny of market practices and a possible review of the regulatory framework to ensure the sector's resilience also in stressed market conditions.

More generally, through increased risk-taking and leverage, non-banks may currently be contributing to the cyclical under-pricing of risks and the amplification of asset prices. If these risks were to unwind in a disorderly manner, this could lead to funding flows drying up and affect the funding conditions of the real economy more broadly. Moreover, distress in the non-bank sector could spread to the banking sector as well, due to the strong links between the two. For instance, euro area non-banks hold over one quarter of bonds and shares issued by euro area banks.

I have argued in the past that, from a regulatory perspective, we need to establish at least two lines of defence for evolving risks. First and foremost, the non-bank financial sector needs to have solid prudential standards. But this will not be sufficient if risks evolve more broadly and across institutions. We will also need an extension of the macroprudential toolkit to the non-bank financial sector, in order to provide the authorities with the means to address risks at system level. While the macroprudential framework for banks is relatively well developed and provides authorities with tools to address cyclical and structural systemic risks, the framework for non-banks is still in its infancy and needs to be further developed.

There are substantial differences between banks and non-banks. When we look at financial stability concerns in non-banks, we are looking less at the risk-bearing capacity of the individual institution's balance sheet and more at the potential for contagion and shock amplification through the system and amplification of the broader financial cycle. So the key risks that we look at relate to liquidity, leverage, procyclicality and interconnectedness. A macroprudential framework for non-banks would need to identify and address the key fragilities and externalities stemming from the non-bank sector, and provide the appropriate tools for authorities to achieve this in an efficient and effective manner.

Such a framework should support the beneficial role that non-banks play in financial intermediation and ensure the sustainable development of non-bank financing. On a note of particular relevance in a monetary union, it would thereby help reap the full benefits of a deep and integrated European capital market. In this respect, the ECB continues to support the further development and deepening of EU capital markets through the capital markets union (CMU), not least in the light of the approaching exit of the United Kingdom.

The United Kingdom's departure from the EU's Single Market will, by its very nature, affect the shape of Europe's future financial market architecture. Non-bank financing of the euro area economy is no exception to this, particularly given the substantial role played by London as a financial hub for European capital markets. Planning by the financial industry suggests that Brexit may result in a substantial relocation of activity to a number of different euro area countries, which may lead to a multi-centric European financial system. In a financial system with a number of increasingly important hubs rather than one dominant centre in London, it will be more important than ever that these hubs can interact with one another efficiently. This will require policies that foster the integration of EU capital markets by addressing barriers to integration and encouraging supervisory convergence. So Brexit is both a challenge and an impetus to our pursuit of the ambitious plans laid out under the CMU.

Conclusions

Let me conclude.

The institutional architecture of the euro area has markedly strengthened in the last decade. With important new institutions, we have seen more robust supervision of financial institutions and the deployment of macroprudential instruments. This has contributed to strengthening our financial system. But we still need to enhance the countercyclical use of our macroprudential instruments by providing adequate macroprudential space to support robust lending and the real economy throughout the cycle. Equally, we urgently need to develop and, where appropriate, deploy the necessary macroprudential instruments for non-banks as well. Finally, we must also pursue the ambitious plans laid out under the CMU to create a deep and integrated European capital market. All of this will allow us to improve financial stability across the wide array of financial institutions and markets that make up the financial system.

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1 See the history of the construction of the ESM in: European Stability Mechanism (2019), *Safeguarding the euro in times of crisis: The inside story of the ESM*.

2 Klaus Regling at press conference after Eurogroup meeting, Luxembourg, 14 June 2019: www.esm.europa.eu/press-releases/klaus-regling-eurogroup-press-conference-19

3 For additional details on the risks, see ECB (2019), *Financial Stability Review*, May.

4 See Draghi, M. (2019), "Twenty Years of the ECB's monetary policy", speech at the ECB Forum on Central Banking, Sintra, 18 June.

5 See Decision of the European Central Bank of 22 January 2014 amending Decision ECB/2004/2 adopting the Rules of Procedure of the European Central Bank (ECB/2014/1).

6 In December 2016, the ECB's Governing Council issued a statement calling for the implementation of legislative frameworks for borrower-based measures in all euro area countries.

7 On the basis of Article 458 of the CRR, Belgium has implemented a 5 percentage point add-on and a 1.33 risk weight multiplier for exposures secured by domestic real estate assets, Finland has implemented a risk weight floor of 15% on domestic real estate exposures, and Luxembourg has recommended a 15% floor on the same exposure.

8 For a detailed overview of macroprudential measures, see the ECB's website (updated quarterly).

9 The CCoB is based on Article 129 and 160 CRD IV, transposed in national legislation. Exemptions for small and medium-sized investment firms are possible. The CCoB is part of the combined buffer requirements to which G-SII, O-SII, Systemic risk buffer and countercyclical capital buffer pertain.

10 See Darracq-Pariès, M., Fahr, S. and Kok, C. (2019), "Macroprudential space and current policy trade-offs in the euro area", *Financial Stability Review*, ECB, May.

11 As of 30 June 2019, seven countries have announced the following rates: Belgium (0.5%), France (0.5%), Germany (0.25%), Ireland (1.0%), Lithuania (1.0%), Luxembourg (0.25%) and Slovakia (1.5%). Buffer requirements are implemented with a 12-month lag.

[12] See Regulation (EU/2019/876) of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, report and disclosure requirements, and Regulation (EU/648/2012) (CRR II).

[13] Excluding central banks.

[14] See Fache Rousová, L and Giuzio, M. (2019), "Insurers' investment in alternative assets", box 9 of *Financial Stability Review, ECB,* May.

[15] For instance, Neil Woodford's Equity Income Fund, an equity UCITS fund which invests in supposedly liquid assets, had to suspend withdrawals after large outflows. In other recent case, following concerns over asset illiquidity, outflows accelerated from bond funds managed by Natixis-owned asset manager H2O affecting Natixis' stock price.