

## Financial stability in Europe: Tackling new challenges

Keynote Speech prepared for the 14th Seminar on Financial Stability Issues organised by Banca Nationala a Romaniei and the International Monetary Fund (IMF)

21.09.2023 | Sinaia | Claudia Buch

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Ladies and gentlemen,

Thank you very much for the invitation to this year's seminar on Financial Stability, organised jointly by the National Bank of Romania and the International Monetary Fund. It is a great honor for me to speak to you today, and I regret that I cannot attend this meeting in person.[1]

14 years have passed since this seminar was held for the first time. 14 years during which the integration of financial markets in Europe has proceeded, 14 years during which a lot of institution-building has taken place across Europe, not least in the domain of financial stability and macroprudential policy. Europe, one could argue, is a front-runner in macroprudential policy coordination.

A functioning macroprudential framework is all the more important at the current juncture. We are in the midst of a process of socio-economic transformation, which requires strong financial markets and safeguards against excessive risk-taking. A sound micro- and macroprudential framework helps with mastering these challenges. In Europe, this framework is based on the supervision of significant banks within the Single Supervisory Mechanism (SSM) by the European Central Bank (ECB), national responsibilities for financial stability and supervision of less significant institutions, and the coordination of macroprudential policy under the umbrella of the European System Risk Board (ESRB). This framework balances responsibilities at the supranational and the national level.

While this framework is still relatively new, it has worked well so far. While severe shocks hit the economy over the past years, the European financial system and its banks have weathered these storms. Decisive policy action by fiscal and monetary authorities has certainly played a role, but European banks have also become more resilient over the past decade.

Going forward, these achievements need to be consolidated and the system needs to be prepared for a changing environment. Strong micro- and macroprudential policies are the foundation of a resilient financial system. Microprudential policy ensures the safety and soundness of individual financial institutions; macroprudential policy addresses the build-up of systemic-wide vulnerabilities. Both complement monetary policy by shielding it from the risk of financial dominance.

In Europe, financial stability is the joint responsibility of the national and the supranational level, reflecting the fact that financial systems differs across countries and addressing potential spill-overs of risks. The use of macroprudential tools varies across countries. Ensuring that the system is working as intended requires assessing of whether risks to financial stability, both domestic and cross-border, are adequately addressed.

And the environment in which supervisors and financial institutions operate is changing rapidly – in terms of the macroeconomic environment and competition on financial markets. Financial institutions as well as micro- and macroprudential supervision need to respond to these new challenges by ensuring that the system remains resilient.

## 1 Macroprudential policy coordination in monetary union

Financial integration is a core element of the European project. It has made significant progress with the introduction of the euro, successive rounds of enlargement, and the formation of the banking union.

Financial integration has many positive implications for growth and risk-sharing, but it also increases the potential for the transmission of negative shocks and spillovers.[2] This is relevant for the European Union, in particular, with its single monetary policy but differences in institutional and financial market structures across Member States. This heterogeneity can be a strength, as different parts of the system react differently to the same shock, but it can also lead to the build-up of vulnerabilities.

Financial integration in the euro area had reached its peak before the global financial crisis and the sovereign debt crisis. Since then, financial integration in Europe has recovered, but it has not yet returned to pre-2007 levels. [3]

Most European financial systems are still predominantly bank-based.[4] However, over the past decade, non-bank credit to EU non-financial corporations has doubled and accounted for 20% of external debt funding in 2022.[5] This shift from bank to non-bank finance certainly broadens access to funding. Yet, higher market shares of non-banks may also put pressure on banks' margins and increase incentives to take on risks. Also, risks might shift to financial market segments which are not as tightly regulated. Both issues need to be monitored carefully.

Beyond the general trend of increasing market shares of non-bank financial intermediaries, market structures differ. Some markets are highly concentrated, dominated by a few large banks; others have a higher share of smaller institutions with a more regional focus.

Take the market shares of less significant institutions as an example. The majority of banking assets in the euro area, almost 82%, are held by the 109 significant institutions supervised by the ECB. Most banks are smaller and more regionally focused less significant institutions, which remain under national supervision. While, on average, less significant institutions account for 15% of total banking assets, their market shares vary from more than 40% in Germany and less than 5% in France.[6]

Likewise, market shares of foreign banks differ significantly. In Romania, for example, 80% of total banking assets are held by the nine largest banks. Of those, six are subsidiaries of large EU foreign banks, which represent around 48% of total banking assets.[7] This shows the importance of financial stability policies that address the risk of cross-border spillovers – through both strong macroprudential policies and coordination at the European level.[8]

Responsibility for macroprudential policy in the EU is shared between the supranational and the national level. National macroprudential authorities need to ensure that relevant vulnerabilities are identified and addressed. But because national authorities may act too late or take insufficient account of cross-border spillovers, the supranational level plays an important coordinating role.[9]

Under the reciprocity framework, national authorities also recognise some macroprudential measures in other EU Member States and apply them to banks with cross-border exposures. The reciprocity framework addresses potential leakages and regulatory arbitrage. Whether measures are recognised depends on the materiality of the exposures and the type of instruments applied. Reciprocity is mostly voluntary, based on a recommendation by the European Systemic Risk Board (ESRB).

## 2 European macroprudential policy in practice

The division of labour between the national and the supranational levels is intended to ensure that domestic vulnerabilities and cross-border externalities are addressed. So how does this work in practice? How do national authorities respond to country-specific vulnerabilities? And does the supranational level step in if cross-border externalities surface or if national authorities potentially react too late?

National authorities use a variety of macroprudential instruments for the banking sector. Take the example of capital buffers. The countercyclical capital buffer (CCyB) addresses cyclical systemic risks in the financial system, while buffers for global or domestic systemically important financial institutions address systemic risk inherent in banks' business models such as size and interconnectedness. All national authorities have identified systemically important institutions and apply additional buffers to them. About half of the authorities in the EU have activated the CCyB, which applies to the banking system as a whole.

Overall, macroprudential buffers account for less than a third of total capital requirements for banks supervised by the SSM.<sup>[10]</sup> The bulk of capital requirements are microprudential, consisting of minimum requirements and bank-specific Pillar 2 add-ons (P2R and P2G).

Macroprudential capital requirements should provide sufficient buffer space to ensure that the banking system does not have to cut lending during a crisis – which would magnify the impact of an initial adverse shock.

Yet, when the coronavirus pandemic hit, there was little macroprudential buffer space available. By the end of 2019, only eight national authorities in the euro area had activated the CCyB. The weighted average rate was 0.23% of banks' risk-weighted assets. National and supranational authorities responded quickly to the pandemic, with the bulk of the €140 billion in capital relief coming from easing microprudential requirements. Only €20 billion came from macroprudential adjustments, mostly from lowering structural buffers, and only €6 billion from releasing the CCyB.<sup>[11]</sup>

In the last two years, many national authorities have made more active use of the CCyB, activating it earlier in the financial cycle and setting it to levels higher than those before the pandemic. Currently, 19 countries in the EEA have a positive CCyB, with buffer rates ranging from 0.5% to 2.5%. Some authorities have implemented a positive neutral rate for the CCyB by setting a positive rate for the CCyB even when cyclical risks are not yet elevated. This ensures that an adequate amount of releasable buffer is available when an unexpected shock hits.

Similar heterogeneity can be observed in the use of buffers for systemically important institutions. Buffer rates for systemically important institutions vary from 0.25% to 3% across Member States. These buffers are specific to the individual bank and the banking system in which it is located. They are thus not directly comparable across Member States.

In the euro area, the ECB also has the power to top up (but not to lower) national macroprudential measures. It can set higher capital buffers than those implemented by national authorities if risks to the financial stability of the euro area are not adequately addressed. So far, the ECB has not used its top-up power, but it has published guidance on the use of its top-up power in the form of a minimum floor methodology.<sup>[12]</sup>

In short, we now have more than a decade of experience with macroprudential policy in Europe, and we can start evaluating its effectiveness more broadly. What drives differences in the use and mix of macroprudential instruments? How do the national and supranational levels play their respective roles? How do micro- and macroprudential capital requirements interact and affect the overall resilience of the system? Are there differences between euro area and non-euro area countries? These, I believe, are important questions that need to be answered to inform future revisions of the EU's macroprudential framework.<sup>[13]</sup>

### **3 Adapting to a changing external environment**

The institutional and regulatory reforms implemented over the past decade have clearly contributed to safeguarding financial stability in Europe. Bank capital and liquidity have increased, and the new institutions that have been put into place function well. As a result, European banks have proven resilient during the past few years, despite the shocks that have hit the real economy, notably the coronavirus pandemic, the energy crisis, and the ongoing Russian war against Ukraine.

But we have to remain vigilant with regard to future risks. To a large extent, the financial sector was shielded from adverse shocks because of highly accommodative fiscal and monetary policy.

At the same time, the external environment in which financial institutions operate is changing. Monetary policy has shifted from quantitative easing to quantitative tightening. Interest rates have risen, and liquidity conditions in financial markets have changed. Macroeconomic and geopolitical uncertainty has increased, requiring a reassessment of credit risk and exposure to fragile value chains. Long-term structural changes, such as climate change, digitalisation and demographic change, affect credit risk.

In short, uncertainty has risen, which makes it more difficult to quantify risks. Going forward, the modelling of systemic risks needs to take into account that the tail risks of the past are the baseline of today. For example, higher interest rates have already exposed interest rate risk on banks' balance sheets, but pass-through is not yet complete. While hidden reserves have declined, the recent increase in bank profitability might not be sustainable. Reviewing the assumptions underlying scenario analyses, improving early warning systems, and interacting with microprudential authorities to understand how the resilience of the system is evolving will be crucial.

Finally, let me stress that policy coordination is important – within Europe, internationally, and across financial market segments. Credible supervision and resolution regimes support each other in terms of setting incentives and addressing emerging risks. Banks, non-banks, and newly emerging financial institutions are closely interconnected through contractual ties and through common exposures. Hence, we need a sound macroprudential framework also for non-banks. Minimum standards need to apply internationally as risks to financial stability do not stop at national borders.

#### 4 References

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#### Footnotes:

1. I would like to thank Rachel Hand and Marcel Heires for their most helpful comments and inputs to an earlier draft. All remaining errors and inconsistency are solely my own.
2. See Buch, Buchholz, Knoll and Weigert (2021), and Lee (2023).
3. See ECB (2022a).
4. See Demirgüç-Kunt and Levine (2019) and ECB (2022b).
5. See ESRB (2023b).
6. See ECB (2023).

7. See Notification by the National Committee for Macroprudential Oversight (Romania) on nine other systemically important institutions (O-SIIs), 22 October 2022 (esrb.europa.eu)  
*[[https://www.esrb.europa.eu/pub/pdf/other/Esrb.notification221020\\_OSII\\_RO~dcaf742ac.en.pdf?50ed4c4833ff19cfe1549876ce9f9fe1](https://www.esrb.europa.eu/pub/pdf/other/Esrb.notification221020_OSII_RO~dcaf742ac.en.pdf?50ed4c4833ff19cfe1549876ce9f9fe1)]*
8. For more on the lending behaviour of domestic versus foreign banks, see Omega, Peydró and van Horen (2015) or Cetorelli and Goldberg (2012).
9. For instance, financial stability committees with strong governance mechanisms and fewer agencies involved are more likely to actively use macroprudential policy. See Liang and Edge (2020).
10. See Aggregated Results of SREP 2022, 8 February 2023 (bankingsupervision.europa.eu)  
*[[https://www.bankingsupervision.europa.eu/banking/srep/2023/html/ssm.srep202302\\_aggregateresults2023.en.html](https://www.bankingsupervision.europa.eu/banking/srep/2023/html/ssm.srep202302_aggregateresults2023.en.html)]*  
. This includes a uniform capital conservation buffer (CCoB) of 2.5% that applies to all banks in all member states. Buffers that are under the discretion of macroprudential authorities, like the CCyB and the buffers for systemically important institutions, account for less than a tenth of banks' total capital requirements.
11. See Behn, Pereira, Pirovano and Testa (2023).
12. See Governing Council statement on macroprudential policies, 30 November 2022 (bankingsupervision.europa.eu)  
*[[https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.gc\\_statement\\_macroprudential\\_policy~4dfa34c05f.en.pdf](https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.gc_statement_macroprudential_policy~4dfa34c05f.en.pdf)]*  
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13. The ECB and the ESRB made suggestions on how to improve the macroprudential framework as part of the European Commission's call for advice last year. See ECB (2022c) and ESRB (2022).