Financial stability risks in Europe

1. Introduction

The Chair noted that there have been a number of recent stress events (failures notably of Silicon Valley Bank and Signature bank of New-York, loss of confidence in Credit Suisse) from which lessons can be learned. The panellists discussed the themes that were most relevant for the banking market: interest rate risk, liquidity risk, systemic relevance, the rescue of banks in difficult situations and resolution. Panellists also discussed the systemic risks that could emerge from the non bank sector.

2. The process of building a more resilient financial system is far from over

2.1 Financial stability does not mean that all risk is eliminated, and ongoing vigilance is needed to identify new risks

An industry representative noted that the global economy has suffered some substantial shocks over recent years, including Covid, geopolitical elements, energy and supply chain issues. One industry that has fared well compared to prior periods is the financial sector, but recent events have put this to the test. It is a timely reminder to be alert to ongoing and newly emerging risks and shocks. The pace at which such shocks can now unfold is striking. Financial stability can never be about removing risk altogether. The essence of market economies is risk taking which can result sometimes of in failure. That is the balance that the system seeks to strike. It is important to distinguish between the pockets of risk in the financial sector and that which threatens the entire system. Prior to recent banking events, crypto was a prime example, where events surrounding the failure of FTX did not have wider implications.

When considering banking results throughout 2022 and into Q1, it would be difficult to discern that war had broken out on the continent. It appears that these risks have been contained and great progress has been made since the global financial crisis (2008-2009). Many remarks have been made this week on how well capitalised banks are. They have more liquidity. Balance sheets have been repaired from lingering bad debts. In essence, it is about building up shock absorption capacity, but the landscape is changing.

The transition from monetary easing to monetary tightening was rapid. Easing took place in an environment of lower cost of borrowing with lower returns. Certain Covid measures created excess deposits. Subsequent tightening measures were implemented at a pace not seen since the early '90s. Fed funds at this time a year ago were zero. Now they are in the range of 4.75% to 5%. The European Central Bank (ECB) deposit rate was below zero. It is now around 3%. As central banks continue with monetary tightening, the cost of capital is rising and leveraged borrowers and positions will come under more pressure.

Advances in technology and communication have been striking. Tweets and banking apps are used to facilitate the rapid movement of deposits. The activities in the non-bank sector and private credit, as well as changing social dynamics, are affecting key sectors such as commercial real estate. It would be surprising if these dramatic shifts did not have any implications for the financial system.

Distinguishing between the pockets of risk in the system and those that are a threat to the overall stability of the system is a responsibility for everyone. The ability to move 25% of deposits off a bank balance sheet in one afternoon is remarkable. Even banks with good capital ratios can experience a dramatic loss of confidence when fragile sentiment is combined with doubts over strategy and governance. The speed of events requires a speedy and agile response to unfolding issues. The current speed of response is not an accident, because, since the financial crisis, there has been a great deal of work in the regulatory space to bolster the system.

In relation to credit, in simple terms, the risk in the system will find the fault line. Market participants will need to be alert and nimble in identifying that issue and the associated transmission mechanisms. First order is the exposure and the reliance of a particular institution. Second order is whether an issue will cause higher risk aversion and credit tightening. Third is policy response and what needs to change going forward.

2.2 Three financial stability risks to be considered

The Chair noted that the job of the European Systemic Risk Board (ESRB) is to consider which of the vulnerabilities of the sector are not just pockets of risk or idiosyncratic but could instead have systemic implications.

A regulator commented that current events are not entirely novel. In September 2022, the European Systemic Risk Board (ESRB) issued a general warning on the vulnerabilities in the EU financial system for the first time in 10 years. A number of accumulating factors of fragility were intertwined. There was an absolute need to ensure resilience and for authorities to foster cooperation in terms of capacity for responses to adverse developments.

Following that warning, the ESRB has focused on three key issues. The first is the interaction between market liquidity and bank funding. Market liquidity and funding liquidity are inherently connected. When market liquidity evaporates, financial market pricing becomes less reliable

and tends to overreact, leading to increased market volatility and higher funding costs. Funding liquidity enables market participants to take exposures onto their balance sheets, thus absorbing fluctuations in demand and supply in the name of efficient market functioning.

The second point is what is happening with residential and commercial real estate. Prices have peaked. Interest rates and inflation are impacting the building industry. There is a contraction in activity in this sector. Credit has tightened. There are also complex interconnections in some sectors with not only banking but also investment funds, insurance and pension funds, and at the international level.

The third area is the macro-financial risk landscape and the implications of persistent elevated inflation, increased nominal interest rates, the movement of long-term yields and how the financial sector is able to address the size and the speed of the adjustment, in terms of movement of interest rates.

Assessing these three factors of risk together also helps providing a perspective on the capacity of the banking sector to withstand other shocks. There is a war and a risk of a further deterioration of geopolitical relations. There are cyber risks. There is widespread political fragility across different countries. All these factors must be considered both at the regional and the national level because the average picture of the European Union is not sufficient, given heterogeneity among countries. Moreover, Europe is integrated in a fragile global financial system. On the other hand, Europe is ahead of the curve in terms of addressing and containing the risk for the first time in many years. A great deal of work has started even before the recent crisis in the US and Switzerland has materialised.

2.3 Financial policies to reassure markets that the EU banking sector is resilient

An official stated that the interest rate risk should not have been a surprise for the financial industry. After a period of low for longer, there is currently a monetary tightening cycle. The ECB will need to continue hiking rates and to maintain tight monetary policy until mid-2024 in order to reduce inflation to 2% by 2025. Monetary tightening is going to continue and needs to stay high until inflation is defeated. Fiscal policy can help. Contractionary fiscal policy will help in the disinflation effort and will allow the ECB not to hike rates as much. This also helps in terms of reducing financial stress, but the disinflation effort should take priority.

Europe has a sound banking system. It is very capitalised, has high liquidity rates, is well regulated and is well supervised. Macroeconomic policy is taking place with this backdrop and therefore can fully focus on bringing down inflation.

There are lessons from the recent incidents for Europe. On the regulatory side, the implementation of Basel III should be timely, with no exceptions and a short transition period. On the supervisory side, Supervisors should reduce uncertainty in markets by enhancing the transparency of banks' unrealized losses on hold-to maturity security exposures. They should also continuously assess banks' liquidity, routinely perform interest-rate risk stress tests, and verify the stability of bank funding structures. With regard to macroprudential policy settings, the plans of raising buffers should continue. This is actually an opportune time, when bank profits are high, because buffers can be built without impacting flow of credit.

Work on the architectural issues must continue. The ESM treaty amendment must be adopted in order to provide the liquidity backstop to the Single Resolution Fund (SRF). Work on deposit insurance must continue and an agreement on European deposit insurance scheme (EDIS) would add credibility to any bank resolution arrangement. The International Monetary Fund (IMF) is supporting the European Commission (EC) proposal to extend the banking resolution framework to smaller and medium-sized banks. Further to that, an exemption for systemic events should be created and more flexibility provided in the use of deposit insurance.

3. Lessons learned from the US and Swiss banking failures

3.1 Constant assessment of capital risk, credit risks and liquidity risks of the banking sector

An industry representative stated that the stark learning from Silicon Valley Bank (SVB) is that there is no substitute for good governance. This is not from the perspective of a regulator but as a practitioner. The other stark reminder is the difference between capital and liquidity. There is constant assessment of capital risk, credit risks and liquidity risks, and they are very different. Capital, or, as it could be referred to, shareholders' equity, is a loss absorption type of measure. These events were not triggered by a lack of capital. Shareholders need to support a financial institution, because that is the capital that can then be levered up and deployed in the system. Therefore, the probability of running out of it is key when it comes to loss absorption ability. The profit needs to then generate an adequate risk adjusted return for the entities that put that equity into the system.

Liquidity cannot be addressed if there is a problem with capital. Lack of liquidity in its worst form is a bank run. A bank run happens when it is not possible to generate the trust required to get the capital in that an institution is contractually obliged to give to someone else. How to avoid losing that trust becomes a key question. There could be refinancing risks, but it can also be linked to capital, namely the ability to raise more of it once there is a concern about profitability, viability or the ability to meet contractual obligations. This was the common theme in all the recent instances. There was an attempt to ask shareholders to commit for the medium to long term and a lack of commitment, triggering follow-on effects. The future regulatory regime is important. Trust and capital should be clearly divided. Trust can be lost in many different ways. Capital is a hard balance sheet number. It is about the shareholder equity availability.

Europe is, for once, ahead of the curve on liquidity. From a European perspective, the way the SVB treasury was

run was not appropriate and cannot be done. Some learnings in Europe from the early 1990s changed this type of riding a yield curve or not focusing enough on asset liability management. Competitiveness is rarely talked about. There are pockets of fantastic financial markets and banks in Europe. There is also a competitive advantage for households, governments and corporations to have easy access to available capital, investments, savings and low transaction costs. There is a balance where all industries and relative comparative advantages should be cherished. How to develop them going forward should be considered.

3.2 A bank must have an operating model that is sound and profitable

An industry representative stated that the latest developments on e.g. fast interest rate hikes are not totally surprising and should actually have happened earlier. But he also pointed out that it was to some extent a surprize in Europe how the Silicon Valley case revealed that US banks have two different sets of regulatory requirements depending on the size of the bank. He emphasized how critically important it is to have a harmonized regulatory framework for the entire sector globally – i.e. treat all banks in the same way and that way establish and maintain confidence and trust in the industry.

One important assessment point for banks is price to book – in this profitability and the respective business models are key to be understood. And adding to this also "speed" – as SVB and CS demonstrated, hesitancy and lack of fast response to the need for speed quickly leads to a deterioration of trust. But of course, also the treatment of investors against the common expectations can lead to a lack of trust. So really trust is key and can be maintained by credible and diversified business models in banks with well diversified risks, harmonized predictable regulation and with action that is in line with expectations in crisis.

The operating or business model has to be extremely strong. No regulation can address that, but regulation is needed to ensure that the institutions that are not strong are addressed. A regulation that investors and other stakeholders can rely on is vital. Europe has made some major improvements although there are still some areas of difficulty, such as capital requirements and internal models, which are related to capital. The variance is clearly too big in Europe.

A public decision maker added that it is key to consider how technology may change the nature of risks. If clients are not sure anymore whether a bank sector will get to Friday with their deposits, and everybody has a telephone to move them somewhere else, than the banking sector as a whole risks to be subject to a sort of first-mover-advantage risk, in the same way as investment funds and money market funds.

3.3 The dangers of so-called self-evident things

3.3.1 Small or regional banks may be systemic

A market expert commented that, if small or regional banks are put together and have problems, they can spread the lack of confidence or trust they have throughout the system at large.

3.3.2 Sovereign bonds are risky

There is an idea that sovereign bonds are a good cushion for liquidity because they are riskless. That is not true because a treasury instrument is a fixed rate instrument and, by definition, very risky.

3.3.3 Stress test should be based on realistic assumptions

Stress tests are how the regulator and supervisor identify what situations could cause problems. In the recent application of stress tests in the United States, there was not a sufficiently high assumption of the increase in interest rates. This maimed the instrument and the capacity of banks to adapt.

3.3.4 Interest rate risk must be supervised permanently

It is believed to be self-evident that the interest rate risk should be the object of sensitivity analysis permanently, not once a year. The Basel instrument that allows for that is interest rate risk in the banking book (IRRBB). IRRBB was not applied in the United States. Previously, a bank rejoiced when it had a lot of deposits because it was a less costly way of funding itself than going to the market. Now it is understood that depositors are not the depositors of previous times. They flee at the first sign of weakness of a bank towards money market funds.

3.3.5 Accounting rules should always be applied in a very systematic way

If there is a portfolio of assets held to maturity, there is an expectation that there will not be a problem because there is an ability to wait for maturity and express no loss. However, if, at the beginning of a crisis, a little bit of that portfolio held-to-maturity is sold, the totality of the portfolio must be reclassified as Available for Sale (AFS). This reclassification rule was not applied in the US. That means that the accounting system was not transparent, but it allowed banks to feel comfortable with the cushion that it provided.

A major change is that market interest rates have very quickly reintroduced themselves into a picture where they were absent for 20 years. This conflicts with regulation and supervision, which has been relatively static. Regulation and supervision must adapt to the changes in all jurisdictions.

3.3.6 Basel regulatory and supervisory requirements must be applied in all jurisdictions. Complacency is the worst of all the dangers of the present system

It is a mystery why supervisors in the United States were so slow to adapt. There has probably been too much confidence in the capability of individual banks to manage their interest rate risk and in the ability of the system to adapt itself. Regulation is for the ones that do not instinctively implement the real governance. It is very important to keep the regulatory system alive, even if the big banks do not really need it. Complacency is the worst of all the dangers of the present system.

An industry representative commented on the EU system and specifically which important specific area needs alignment and discussion on a broader EU level. He elaborated and raised a concrete problem in EU in relation to capital requirements, and especially macro

buffers. (Unlike in respect of micro buffers where level-playing field is pretty strong,) Macro buffers for banks are currently not at all coordinated nor aligned and are left entirely on national discretionary decisions. This leads to non-understandable outcomes where the relative risk levels do not match the capital requirements of respective banks. This in turn is not at all understood by investors and other stakeholders when they compare banks and leads to an unfortunate un-level-playing field and deterioration of competitiveness. This must be addressed in EU with determination – otherwise we might see similar destinies as we saw in the US.

An industry representative stated that the banking industry should use a different filter than the size of the balance sheet and the counterparties that a bank has. It must be made simpler and identify where a bank is significant. It has been demonstrated that a fairly small player can, with reputable people with a large following on Twitter, make very large dislocations very evident, which are very painful to address. Large banks are regulated with respect to investor protection. Giving advice today is very well regulated, compared to speaking about a company on Twitter with millions of followers. That is free to do and will lead to movements in the market that are very difficult to counteract.

The Chair commented that assumptions based on a past that has maybe been stable for a long time should be questioned. There were assumptions that the system was dealing with risk in a way that was adequate, for example interest rate risk in the banking book. This is not only a US phenomenon. It is a pillar 2 part of the banking regulation. If it is in pillar 2, that means that either the bank or the supervisor has to address it. If it is in pillar 1, it is automatic. If neither the bank nor the supervisor are addressing it there will be problems. It is the most basic risk in banking that has been there since the bank balance sheet was invented.

The nature of the stability of deposit funding should be considered and the liquidity regulation reviewed. This was only invented globally after the last financial crisis to disincentivise short-term wholesale funding. It has now become clear that short-term retail funding is not appropriately calibrated in that regulation. The world has changed in its speed. Liquidity regulation is just about codifying a liquidity stress test and some of the parameters are probably wrong.

4. Strengthening the resilience of non-bank financial intermediation

4.1 Analysis of the lessons of the failure of Credit Suisse is needed, but work on the resolution of GSIBs has made progress

The Chair commented that there are a number of areas of discussion raised by recent events. One of them is where the threshold for systemic relevance is. Under duress, threshold is set lower and lower to avoid psychological contagion. If in doubt, everything is systemic. Adopting this view ex ante would impact the costs of preparing and executing bank rescues. Secondly, there has been a live test in the failure of a global systemically important bank (GSIB) in recent weeks.

An official stated that the recent event was the first time since 2008 that a GSIB experienced stress, so the first real test of the Financial Stability Board (FSB) post-global financial crisis (GFC) reforms, in particular of the key attributes for effective resolution regimes. The FSB is a standard setter for resolution and this raises questions. It is unfortunate that there have been public statements about the credibility of the resolution regime, given that it was not applied. The governor of the Banque de France suggested that some soul searching would be necessary. There has been pre-emptive government or state action, taking account of the resolution planning and the resolution regime.

Analysis is needed, but the current situation is much better than 12 years ago. Resolution authorities have powers. Resolution planning has been carried out. Including Credit Suisse, the GSIBs have simplified their structures and issued bail in able capital instruments. The sequencing of allocating losses can be discussed, but loss absorbing capacity was available. Much has been done to support operational continuity in resolution and continued access to financial market infrastructures. Authorities were served well in recent events by the setting up of crisis management groups, underpinned by cooperation agreements, so officials knew who to contact. Connections were established that facilitated communication in the crisis. Authorities also developed a common understanding of their respective objectives and approaches to resilience.

The fundamental question that the recent Credit Suisse case raised is how to restore the trust and confidence of markets when a bank enters resolution. Banking is fundamentally about trust. 2023 is different to 2008. A Twitter-induced digital bank run is different from a capital crisis where there are toxic assets on the balance sheet and there is time to sort out the situation. Here, there was need for sizable liquidity.

The FSB has identified funding and resolution as a fundamental issue. Much has been done to support and facilitate private sources of liquidity. The FSB considered mobilisation of collateral and vulnerability across jurisdictions. The importance of public sector backstop arrangements was an important lesson. The features that such arrangements need to be effective will be considered in detail. In particular, in Europe the size of the arrangement has been identified as an important issue.

Supporting confidence, certainty and predictability matters a lot to markets. Executing a resolution gives rise to many questions: if total loss absorbing capacity (TLAC) is bailed in, who will run the bank? Who will own the bank? What will be the new business model? Will customers or bankers remain with a bank in times of uncertainty, where it is also not clear how quickly the plan can be executed in a cross-border context?

GSIBs have focused on the development of so-called bail-in resolution strategies. A question is whether more optionality and flexibility, combining bail-in strategies with sale of business transfer strategies, should be considered. The FSB will consider the case in

depth, in close collaboration with the Swiss authorities, and study the US cases to understand the implications for current policies.

4.2 Insurers and pension funds have successfully navigated recent stress events but there remain headwinds

4.2.1 A robust supervisory framework based on a mark-to-market full balance sheet approach, covering the whole risk profile of an industry, is key to containing the impact of adverse economic and market developments

A regulator stated that recent events in the US suggest having liquidity data as an insurance supervisor is good, even though liquidity is not the first concern of a supervisor. It enables an assessment of whether the current exposure is concerning. European insurers have significant interlinkage with banks, particularly through investments in bonds and market corrections would lead to mark to market losses for insurers depending on individual exposures. Their significant exposure to banks is assessed, as such, what is happening in the banking sector is very relevant. Considering the insurance sector as a whole, rising interest rates are good news.

The robust EU regulatory and supervisory insurance framework, with a balance sheet that is fully marked to market and a pillar 1 that includes all risks, is not a guarantee for stability, but it definitely helps. It also has an impact. At year-end 2021, there was 10.5 trillion in assets in the insurance market in the EU. That has come down to 9 trillion as of year-end 2022. Nevertheless, liabilities are also coming down and the average (?) solvency ratio remains the same at a comfortable 250%.

4.2.2 Liquidity and synthetic leverage need to be closely monitored

It has already been stated that complacency should be avoided. Liquidity risk must still be monitored, particularly because liquidity risk can sometimes arise much faster than expected. Liquidity risk can be triggered by policyholder behaviour. There are two issues: There is one thing that is really new, which is the cost-of-living crisis. Inflation reduces consumer purchasing power. It might simply be that people, even though they will pay a penalty, they will lose a tax benefit, still see a need to lapse their policies. We slowly see that happening now. It is not at a concerning level, but definitely something to monitor. The other aspect of policyholder behaviour is not taking additional products and not renewing non-mandatory non-life insurance. The question is whether it will be possible to write more business at a time of a cost-of-living crisis.

Synthetic leverage also needs to be watched carefully. In a system where full mark to market is operated, there must be consideration of interest rates going down. This is hedged for. When interest rates go up, there will be margin calls, as happened very quickly in the gilt crisis in the UK market. Speed was very important. A great deal of liquidity in the form of cash was necessary. Acting on that had an impact on the market. How likely this is to happen in the EU can be considered. It cannot be ruled out, but the situation is very different. Pension funds in the UK are a very big fish in a small pond, whereas pension funds in the EU are relatively small fish in a very big pond. Liquidity is deeper in the EU market and the diversity of investment with the different government bonds also makes it less likely that this will happen. Nevertheless, more liquidity testing, or continuing liquidity testing, is also relevant in insurance, particularly for managing this risk.

4.2.3 The pension gap and climate change risks require further consideration

Two important risks from a financial stability perspective are serious but not yet much discussed. First, there is the pension gap in Europe. One in five European citizens is at risk of living in full poverty in old age. 35% of those are women and, in general, women receive 30% less. This is a difficult discussion because a pillar 1 system, social and labour law will need to be combined with events in pillars 2 and 3. This is relevant to the need for more retail investments and for people to be more conscious of how they save for later, again at a time of a cost-of-living crisis.

A second issue is protection gaps, and, in particular, natural catastrophes (nat cat) risks. Because of climate change, the intensity and frequency of events is going up. In the current round of renewals for reinsurance prices are going up by 40% to 50% across the market. There will come a point where that is unaffordable. Together with the ECB, EIOPA recently published a report discussing these risks from a financial stability perspective. How to increase the capacity of an insurance market together with other parts of the financial industry must be considered. How the public-private partnerships can stand ready should also be discussed.

4.3 The FSB has undertaken work to assess and address the risks from NBFIs

The Chair noted that work on non-bank financial institutions (NBFIs) has been ongoing since the last financial crisis but sometimes seems to be less of a priority. Pulses of systemic risk and contagion in the markets have come from this sector.

An official confirmed that the FSB has been monitoring the NBFI ecosystem since the global financial crisis, publishing an annual report. As a result, much more is now known about the size and the risk from a systemic perspective. However, regulators have not kept up with the very significant growth of the sector. The lack of transparency did not enable them to effectively monitor it.

After the 2020 market turmoil, a holistic review was conducted and a work plan developed, which contains deliverables to the G20. These include a consultative report on addressing liquidity mismatches in open ended funds that will be published in the coming month. There will also be further assessment of the vulnerabilities associated with non-bank leverage, how to address sources of liquidity imbalances and developing a more comprehensive toolkit that is also effective from a system-wide perspective.

4.4 Financial stability risks from energy derivatives markets

A regulator commented on the need to reflect on past mistakes. He explained, for example, that, when the ESRB had to express a view on the systemicness of third countries' central counterparties (CCPs), it immediately excluded all those that were working in the UK and the US with commodities, because they were considered relatively small. Shortly after, a potentially serious incident in the nickel market in the City was avoided only because the stock exchange there decided to do something that nobody had thought of, i.e. cancelling one entire day of orders. The rules of the game were changed to preserve markets from a deeper collapse. That is the equivalent of the Swiss changing the order of preference between equity and bond holder and the Americans extending the guarantee to everybody. Also, last summer, there were widespread liquidity problems after large margin calls at the Title Transfer Facility (TTF), due to a war-driven squeeze on gas prices. To avoid energy market failures in a highly delicate geopolitical situation, several governments had to intervene with credit lines and other subsidies. Also unthinkable, a few months before.

We need to ask ourselves critical questions on whether we would need to take the same exceptional measures in the future in case of materialisation of much more severe tail-risks. If the CCP world is exposed to tensions for relatively small-sized derivative markets like those for nickel and gas, what would happen if there were a sudden, unexpected interest rate shock in the financial sector, which would bring to a very large and sudden margin call request? I mean, a huge one. Interest rate swaps are a much bigger market than commodities. Whether CCPs are strong enough to cope with much larger, almost generalised episodes of fragility has been of course subject of severe stress test exercise by ESMA (which is an institution with a high reputation), and with good results (also with the ESRB's support), but of course remains to be tested in real life. Simply, reality is sometimes beating what we expected to be the worst scenario. These are topics for the future.

An industry representative commented that there was an issue with electricity in their region. A utility client was asked to post €9 billion of collateral in one afternoon. The client had 30 minutes. That demonstrates the impact of liquidity on the most reputable, highest creditworthy counterpart. This is not about solidity. It was not possible to generate liquidity at that speed.

How to regulate shadow banking, not so much in respect of reputable pension funds or insurance companies, but more in respect of fintechs and start-ups, should be considered. However, innovation and the spirit of trying something new should not be stifled.

The Chair commented that, until the very significant pulse of risk came out of the UK pension sector, it was surprising that, with the rapid change in the environment, there had not been more spill-overs out of the non-bank sector. If what one family office, Archegos, caused in terms of losses for the banking system is considered, there was a concern that more of these incidents could arise, because the sector is much less transparent. He added that there is an idea that things that have happened elsewhere would not occur in Europe. This thought should be treated with caution. What could happen here should always be considered. Some of the dynamics discussed are globally identical. Everyone who runs supervisory authorities knows that they should be wary of criticising colleagues because the reputation of each authority is only as good as the distance from the last crisis in its supervised sector. There is a need for humility when identifying the weaknesses in a supervised system or observing the weaknesses in others.