KEY MACRO AND MICRO RISKS

1. Increased uncertainty and risk is negatively impacting on the global and EU macroeconomic outlook

While there was broad agreement between the panellists on the macro risks facing EU financial markets, the panellists highlighted several different trends contributing to the negative macroeconomic outlook.

1.1. There is consensus on the list of global risks

A Central Bank official felt there has been a series of negative surprises at the global level, including the resurgence of trade tensions between the US and its partners, tensions around the Italian budget, the British Parliament's rejection of the Brexit deal and the gilets jaunes movement in France. An official agreed, suggesting that the list of global risks comprised: political risks, including Brexit; trade tensions; potentially distorting market developments associated with the normalisation of monetary policy; cyber-risk and other risks associated with technological developments; and higher indebtedness of private sector agents and jurisdictions.

1.2. Continued low funding costs and the 'search for yield' environment can lead to the mispricing of risks and encourage excessive risk taking

A regulator considered that the present situation in Europe is similar to the situation it faced several years ago. At that time, Europe did not have buffers which it could release to support growth. Europe, however, has lost the opportunity to build-up these buffers over the past several years. The regulator emphasised that this is the shared responsibility of many of the Eurofi attendees. The pushback against the use of macroeconomic policy from the financial sector is driven by the belief that macroprudential policy kills growth. This has created a situation where Europe does not have the instruments required to support growth. The continuing low interest rate environment, which is a structural problem, leads to a situation in which bubbles are developing while there are also serious risks to growth. These issues could have been tackled if Europe had activated the systemic risk buffer and the countercyclical capital buffer. The deceleration of growth could be accompanied by proper monetary policy, but monetary policy cannot at present deliver this.

An industry representative noted that global debt is higher and perhaps riskier in some areas than it was 10 years ago. There is a great degree of financial, political and social fragmentation in a context of low growth and low inflation. In terms of the European financial sector, however, the main risk is the extended period of low interest rates. Low interest rates are among the root causes of the low profitability of European banks. While banks' balance sheets have improved quantitatively and qualitatively, profitability has returned to the low levels observed in 2009, 2012 or 2015. The low profitability of banks delays the reduction of non-performing loans and the strategic investment in new technologies. If the European banking sector retrenches, there will be an implication in terms of employment and then growth. This is a 'doom loop'.

A regulator suggested that political uncertainty, including Brexit, could be a significant risk. This is a difficult topic, because each new development in politics is unique. While much has gone wrong from a political and institutional perspective in relation to Brexit, the Brexit process has been marked by an absence of market incidents and strong institutional discipline. Measures such as reciprocation and recognition have resolved the problems related to the 'cliff edge' effects and a number of things are now functioning well. One important question to answer is whether the financial market is strongly underpricing the impact of Brexit on the real economy or the events that could follow the Brexit process. The regulator considered that the financial sector has developed the capacity to understand institutions. It understands that Central Banks have a clear policy function, which is to anchor monetary expectations and avoid deflation. It is important for the industry to understand that the policy functions of Central Banks may no longer be targeted on supporting the financial sector when the market exits the current situation. It is clear that Central Banks cannot conduct monetary policy to support the interest rate margins of banks or to protect pension funds or the insurance sector. Market participants could be surprised to discover that the profile of monetary policy has not been completely priced.

1.3. The economic impacts of these uncertainties

A Central Bank official noted that these global uncertainties had weighed negatively on the global and European macroeconomic outlook, which is now less favourable than anticipated. However, Europe is not heading towards a recession; rather, expansion is slowing. This situation exacerbates the risk faced by financial institutions and raises greater concerns over the sustainability of high debt levels, especially in the event of an upward shock to interest rates or a downward shock to activity. This growing uncertainty feeds the risk of an abrupt downward correction in financial asset prices, which appear elevated from a medium-term perspective.

An official agreed that there had been clear signs of a deceleration in global economic activity over recent months. This phenomenon has led to several international organisations revising downwards their forecasts for growth for 2019 and 2020. Most Central Banks are signalling that the process of monetary policy normalisation could take longer than anticipated. Therefore, any eventual risks associated with that process are being pushed backwards.

1.4. The additional risks linked to the sovereign Central Bank loop

An official highlighted the risks posed by the ECB sovereign loop, which relate to the large holdings of private sector assets by the ECB. A Central Bank official agreed that Central Banks around the world hold significant portfolios of government debt, but this does not threaten the capacity of Central Banks to act during periods of market stress. The question is about the impact of market movement on Central Banks' balance sheets when portfolios are held to maturity. The Central Bank official however doubted that this would have a significant impact.

An industry representative considered that this issue depends on the time horizon. However, there is a risk in the Central Banks' search for 'a new normal'. The current environment is one of low interest rates for longer periods of time. The typical recession signals that market monitors, such as the inversion of the yield curve, are impacted by the composition of the balance sheets of Central Banks. While QE was necessary, the resulting inversion of the US yield curve has

made the market nervous, because they are no longer able to read the business cycle.

1.5. The long-term risks to financial stability posed by digitisation, 'big techs' and climate change

A Central Bank official felt that digitisation is the most important risk to the financial sector. Cyber-risk and digitisation are issues on which market participants should cooperate. It is vital for the industry to understand the implications of these risks and to run scenarios and verify on both an individual and a collective level that their schemes to address this are appropriately adapted and have a compatible, ensuring collective resilience.

Additionally, BigTechs are changing the structure of the financial industry. These organisations have pricing policies which affect the P&L of incumbents. This raises an issue for supervisors, because these market participants are outside the financial sector. So far, the regulation and supervision strategy has addressed third-party service providers indirectly through contracts and the management of contractual relationships between banks and providers. The indirect reach of third-party providers raises a fundamental question about the scope of regulation and whether these market players should not also be subject to regulation, since they have a significant impact on the financial industry and contribute to systemic risk.

The other important long-term risk is climate change. The industry must determine its exposure to climate change risks, but it can also contribute to financing the green transition.

2. Mitigating these risks remain challenging

There are several factors which make addressing macroeconomic risks difficult and there are several outstanding challenges.

2.1. The room for manoeuvre regarding monetary, fiscal and macroprudential policies is limited

Macroprudential policies can only play a limited role in addressing these risks. In particular, macroprudential policies may be needed to smooth a possible credit contraction because European banks have not built the necessary prudential buffers, because Europe has not built the necessary monetary and fiscal buffers. The few countries that have enacted macroprudential policies have done so because of financial instability risks. Such risks have not been sufficiently reduced for these countries to consider reversing these policies. On the contrary, due to the deceleration in the economy and an extended period of low interest rates, financial imbalance risks could further increase, which may necessitate additional pro-cyclical macroprudential policies. The room for manoeuvre on fiscal policy is relatively small. Some countries have some space due to their comfortable fiscal situation, which should be exploited if necessary. In respect of monetary policy, the fact that interest rates are at record lows means there is not enough 'dry powder' for monetary policy to counteract deceleration.

An industry representative agreed that monetary policy is not a viable instrument. Interest rates have been 200 basis points lower than nominal GDP growth for nine years in the US and five years in the eurozone. Central Banks have 'bought a lot of time', but monetary policy cannot alleviate the consequences of ageing societies or raise productivity and GDP. The industry representative highlighted the importance of making smart use of available fiscal space. This should not be used to stabilise short-term economic downturns but rather to raise potential GDP with a long-term investment strategy. A French style industrial policy would make sense at the European level. This would involve the public financing of public infrastructure projects aimed at developing knowledge and acquiring new technologies. Additionally, Europe needs greater coordination between national policies. Tax policy should be a level playing field.

2.2. It is the right moment to activate macroprudential tools to address corporate-sector leverage

A Central Bank official felt it is important not to be excessively 'gloomy' on the topic of low interest rates. The time is right to take action, particularly in respect of macroprudential policy tools, because the market is in the upper part of the financial cycle. In that context, one important risk is corporate-sector leverage. While non-financial firms may appear on a global average basis not to be a cause for concern, a deeper analysis demonstrates that there are pockets of risk in the non-financial corporate space. France provides a compelling example of this. In France the level of corporate debt is growing faster than the euro-area average. Looking deeper, a subset of large groups has had very high levels of leverage. In 2017, France took macroprudential action by using the large exposure limits of banks and activating the countercyclical buffer. This was intended to increase the shock-absorption capacity of the banking system and ensure that credit will continue flowing in less favourable economic circumstances, but this kind of tool reaches its limit when credit is being provided by institutions other than banks. One of the issues here is about how to extend macroprudential policy to these players to ensure they also contribute to the resilience of credit flows in the case of a downturn in the financial cycle.

A regulator congratulated the French authorities on their use of macroprudential tools. In reality, the legislation only permits these problems to be addressed via the banking system. This puts banks at a long-term disadvantage. Lending from the non-banking sector impacts on how the countercyclical capital buffer is calculated, although banks ultimately pay for it. While the non-banking sector does not generate systemic risk, the regulator emphasised that it does amplify it. The industry must learn how to address this amplification. Additionally, while forbearance can be useful, it is not good by definition. There must be a proper legislative basis for the use of economic policy tools and a good calibration of regulations. This is an area where legislators must take decisions; it is not sufficient merely to discuss these problems.

2.3. Understanding the implications of regulation

The regulatory environment means that banks are well prepared, but banking regulations can produce unintended consequences. An industry representative expressed doubt as to whether he could provide an optimistic view. Clearly, the financial industry is more resilient than it was 10 years ago. There is more capital and liquidity, and the industry is safer. However, in areas like Europe and Japan the banking sector is probably not fulfilling the needs of society at large.

In respect of regulation, the industry representative feels there is a paradox. The more granular and prescriptive rules are, the safer the banking sector is. However, the complex and detailed nature of these rules incentivises banks to take a tactical approach to compliance. The sector is resilient, but it may not be functioning properly. The industry is doing everything it can in terms of interest rates and monetary policy, but money is not circulating. When more rules are introduced, banks take a tactical or siloed approach. These banks do not make profits and vulnerabilities are not addressed, which leads to the introduction of more rules. This vicious circle must stop somewhere. The industry cannot blame regulation, but regulation must be considered from a holistic perspective as opposed to on an individual basis.

The industry representative considered that the industry is prepared for the next shock. As a G SIB, MUFG is in the

process of complying with all of the post-financial crisis reforms. However, it is important to understand what kind of shock is contemplated by specific regulations. The discussion so far has covered financial shocks, but a shock could be provoked by a cyber-attack or a natural disaster. There are now many requirements concerned with preparing for financial shocks, such as stress-testing. The efforts centred on recovery and resolution are also important, because they will create tools for the recovery of liquidity and capital. However, the industry should consider the possibility of unintended consequences. The use of a standardised approach might create risk by incentivising financial institutions to react to stress in the same way. Ultimately, the industry might create one risk by addressing another. Additionally, the industry representative noted that the transition to risk-free rates could challenge banks' business models.

2.4. Bank overcapacity and profitability remain challenging in Europe

Banks are able to address these risks, however. They have more and better-quality capital as well as larger liquidity buffers than before the global financial crisis. Risk and compliance functions have now become an essential part of their organisations. In Europe, the banking sector has been made more resilient through major institutional reforms, including the creation of the Single Supervisory Mechanism and the Single Resolution Mechanism. More broadly, the financial system operates in a sounder regulatory framework due to the G20 financial reforms.

An official emphasised the importance of acknowledging that the solvency position of financial institutions in Europe has improved markedly. Secondly, European authorities have done a terrific job in promoting a significant reduction in non-performing loans. The key problem is profitability. This is partially caused by the low interest rates produced by expansion in monetary policy, but there are also much deeper structural reasons for it. Certainly, there is overcapacity in the European banking sector. It is not the case that the ECB should raise rates to restore profitability. This would have several other negative implications. Ultimately, the problem is about revenue. The official side should promote an orderly restructure of the industry such that the remaining banking institutions have a sustainable business model.

An industry representative noted that overcapacity is a difficult topic to address, but the solution is not further regulation. Over-banking cannot be directly addressed by regulation. This problem is not merely over-banking but the over-supply of deposits. If there is insufficient demand, not much can be done. The banking business is about taking and managing risk. Banks follow money, and money follows demand. The solution to this problem is to create real demand. This problem must be solved in the whole economy, not just in the banking sector. The industry representative conceded that there is no clear-cut answer to this problem.

2.5. Addressing the deficiencies in the EU crisis-management framework

An official stressed the importance of considering scenarios in which risks could occur and understanding the institutional arrangements in place to manage the situation. There is now a state-of-the-art resolution framework in Europe. No other jurisdiction in the world follows more closely the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions. This should provide a basis for managing a crisis of systemic institutions with no or very limited involvement of taxpayers. There is now a fully effective resolution authority; there are common rules to be applied in crisis situations; and the SRF should facilitate the resolution of institutions. Additionally, the ESM backstop for the SRF has now been agreed.

However, there is a general concern about how this system will function in practice. There is uncertainty about the functioning of the new resolution framework in a cross-border context. The rules are not yet sufficiently clear on the distribution of MREL between subsidiaries across pan-European banking groups. These arrangements must preserve financial stability while avoiding excessive constraints on pan-European groups. Additionally, it is unclear whether the ESM facility for the SRF will be sufficient, considering the potential for bank runs during resolution. It would be an incredible mistake not to implement mechanisms to ensure institutions receive liquidity support in these circumstances. There are also concerns around how resolution will function for small and medium-sized institutions. The problem is particularly severe for institutions which are too large to be liquidated according to domestic insolvency procedure but too small to meet the CRF's resolution requirements. An administrative regime similar to the FDIC might be helpful. An alternative strategy would be to develop administrative regimes at the national or domestic level. Hopefully the European Commission will produce some guidelines on this issue.