

EUROPEAN FINANCIAL STABILITY



AGNÈS BÉNASSY-QUÉRÉ

Deputy Governor - Banque de France

A resilient financial system in the face of rapid monetary tightening

The rapid tightening of monetary policy between 2022 and 2023 has not resulted in major financial instability in the European Union at this stage, despite exceptional levels of uncertainty. This resilience relies largely on the soundness of our banking and insurance sectors, reinforced by the European model of stringent regulation and efficient supervision and on an orderly pass through of monetary policy to the real economy.

The transmission of higher interest rates to non-financial corporates (NFC) and households results in increases of interest payments and lower financing flows. However, these impacts are gradual in countries like France, with a relatively high share of fixed-rate borrowing and a long-term structure of outstanding debt. While French NFCs are still highly indebted they have been able to absorb the deterioration of their interest coverage ratio so far and their credit risk remains contained overall. The number of corporate bankruptcies rose in 2023, but remained below its pre-pandemic average. Households also remain resilient thanks to the robust French home financing model and measures taken by the prudential authorities. As a result, French banks' asset quality remains stable.

However, vulnerabilities associated with non-financial sector indebtedness remain on the upside, especially for the most heavily leveraged participants, as the transmission of higher interest rates is ongoing. These vulnerabilities could be exacerbated in the event of an additional macroeconomic shock or if financing conditions tighten further.

Amid heightened geopolitical tensions and ongoing macroeconomic uncertainties, financial markets remain exposed to shocks especially if expectations of a soft landing of the economy, as reflected in equity and corporate bonds valuation, turn out to be overly optimistic. Moreover, volatility remains elevated on global bond markets. Notably, between the end of August and October 2023, long yields spiked before easing back, fueled by shifting monetary policy expectations and by a contagion from the US Treasuries market. Yet European sovereign debt markets have remained fully functional in this context of high volatility, with no signs of fragmentation across countries.

Overall, the absorption of ongoing normalisation of the Eurosystem's balance sheet (quantitative tightening) has been orderly so far. However, a localised market shock could strain the liquidity of some vulnerable non-bank financial participants, with potential side effects for the wider financial system. These

participants could experience significant financing needs in the event of a market shock, via margin calls or redemption requests, which could strengthen adverse market dynamics through forced asset sales. While the share of non-bank financing remains small in France, high interconnectedness between NBFIs and with the banking sector increase risks of contagion.

In a context of higher funding costs, French banks exhibit robust liquidity and solvency levels. They rely on a diversified funding base, as debt securities issuance represent 15% of funding, and deposits 60%, with a healthy balance between household and corporate deposits. Outstanding deposits are broadly stable, with significant reallocations into interest-bearing deposits. Reflecting this, liquidity indicators are not signaling vulnerabilities, whether at the individual or system-wide levels. Solvency ratios at French banks remain elevated, as confirmed to by the results of the European Banking Authority's 2023 stress-testing exercise. Euro area banks have enjoyed robust earnings growth, mainly due to wider interest margins, but uncertainties around earnings outlook have increased in a context of rising funding costs and slower lending dynamics. French banks got temporarily less of an income boost from higher interest rates than banks in other jurisdictions. Their net interest margin contracted slightly as the cost of their liabilities rose faster than interest income. However higher rates are expected to benefit them over the longer term.

Markets risks remain elevated and could create liquidity stress for vulnerable NBFIs intermediaries.

Going forward, the financial system continues to face growing risks which call for close vigilance. NFCs and other real economy participants still have to absorb the remainder of the monetary policy pass-through and will face a slower growth environment. Markets risks remain elevated and could create liquidity stress for the most vulnerable non-bank intermediaries.

Banks and insurers are adapting to the interest rate environment thanks to their solid balance sheet structure but need to remain vigilant. On top of these cyclical challenges, the financial system still needs to step up its efforts to adapt to cyber and climate risks.



KERSTIN AF JOCHNICK

Member of the Supervisory Board - European Central Bank (ECB)

Financial stability under European banking supervision

European banking supervision was established to ensure that banks remain safe and sound and the financial system remains stable. The decision to grant the ECB supervisory powers was taken in the aftermath of a severe financial crisis which revealed that it was untenable for monetary policy to be managed at European level while banking supervision and resolution remained the preserve of national authorities. The single European supervisor was billed as the first of three pillars in a banking union that was meant to overcome the fragmentation of the financial system along national lines.

It's now been almost ten years since European banking supervision was established. So has the single supervisor delivered on its promise? And how can we adapt the financial stability agenda on the basis of what we have learned?

Resilient banks

Standard performance metrics for our supervised banks show that, in aggregate terms, they are now in much better shape than when they first came under ECB supervision in November 2014. The fact that this improvement has been sustained in spite of the large negative shocks that have hit the banking sector in recent years, including a global pandemic and the fallout from Russia's war in Ukraine, makes this development all the more remarkable.

In my view, the resilience of the banking sector can be attributed to two factors.

First, ECB Banking Supervision deserves credit for raising the common standard for the entire system. Various initiatives were instrumental in restoring confidence in the banking sector, including progressively lifting the capital bar faced by banks, focusing on reducing legacy non-performing assets and reviewing banks' internal models. These and other actions also mean that banks are generally in a better position to deal with external shocks when they materialise. It is also important to recognise that overhauling the Basel framework after the great financial crisis enabled these higher supervisory standards to be reached. This is why I believe that the revised framework has proven its worth – and also why it is crucial that the remaining Basel III standards are integrated into European law.

Second, when confronted with challenges on an unprecedented scale, both European and national policymakers have shown that they can act quickly and work together to respond appropriately to the severity of the situation at hand. Banks have also indirectly benefited from the support that was provided to the real economy, as this prevented the full impact of adverse shocks to growth from feeding through to their balance sheets.

Integration and crisis management

Over the last ten years, better regulation, more efficient supervision, well-capitalised banks and strong institutions have all helped make the banking sector more stable. While we should be pleased

with this development, we also know from our experience during this time that no two crises are likely to be the same. Thinking that past success is a reliable bellwether for future performance could be tempting, but it is ultimately foolish. We know that banks will continue to face a number of headwinds, as they are still adjusting to the recent sharp interest rate increases even as the near-term economic outlook deteriorates.

In order to further cement the resilience of our banking system, we need to foster the creation of a truly integrated banking market, refine our crisis management framework and address the gaps in our macroprudential framework.

First, we need to complete the banking union as originally foreseen. Advances in supervision and resolution under the first two pillars have helped weaken the links between banks and their sovereigns. However, as long as the third pillar – a common deposit insurance scheme at European level – is missing, there remains the possibility that the “doom loop” between governments and banks will resurface. Making progress in setting up the third pillar should also foster bank mergers across national boundaries, which have so far failed to materialise to any meaningful extent.

Second, the process for unviable banks to exit the market could be improved. The scope of resolution can be expanded to ensure that the failure of small and medium-sized banks can be addressed in a harmonised manner, and deposit guarantee schemes can be empowered to provide a wider range of crisis management options to address potential or actual bank failures. The recent proposals by the European Commission are a welcome step in this direction.

Finally, recent experience also suggests that policymakers will continue to be confronted with the question of how to ensure banks can use their buffers more effectively during a crisis, including by adjusting macroprudential frameworks to make these buffers “buildable” and “releasable” in a countercyclical manner.

1. Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).
2. For example, the weighted average CET1 ratio for banks supervised by the ECB increased by 4.7 percentage points between the fourth quarter of 2014 and the third quarter of 2023, while banks' liquidity coverage ratio rose by almost 29 percentage points, to 159%, over the same period. During this period, the NPL ratio of banks supervised by the ECB dropped by 6.1 percentage points, to 1.9%, in the third quarter of 2023, the latest quarter for which data are available.
3. This is also borne out by empirical studies. See, for example, Haselmann, R.F.H., Singla, S. and Vig, V. (2022), “Supranational Supervision”, LawFin Working Paper Series, No 50, Goethe University, Center for Advanced Studies on the Foundations of Law and Finance.
4. European Commission (2023), “Banking Union: Commission proposes reform of bank crisis management and deposit insurance framework”, press release, 18 April.



MARGARITA DELGADO

Deputy Governor - Banco de España

Navigating an uncertain and challenging environment

The crucial fiscal response to the outbreak of the COVID-19 pandemic led to significant increases in public debt levels among EMU member countries. The fiscal measures adopted since 2022 in response to energy and food price inflation have also contributed to maintaining the expansionary stance of this policy. Tighter monetary policy is increasing the cost of new public debt issuance, although its pass-through to the average cost of outstanding debt has been relatively slow due to the earlier lengthening of public debt maturity.

In any case, high public indebtedness represents a key vulnerability in the EMU, as it elevates cost sensitivity to potential new financial shocks and limits the fiscal space available. Thus, in 2024 European fiscal policies should generally adopt a tighter stance, within the new fiscal framework agreed by the Ecofin in December 2023.

Amid high inflation and rising interest rates, the debt servicing capacity of European households has been sustained by resilient employment, the recovery in real wages and the savings built up during the pandemic. In the case of non-financial corporations, the deleveraging in some countries following the global financial crisis (GFC) and the recovery in mark-ups after the pandemic have also helped to sustain their debt servicing capacity.

However, debt service-to-income ratios are being pushed upward and pressure could mount if downside risks to GDP materialise. Monitoring these risks remains a priority for financial stability authorities, even though markets are projecting lower interest rates.

At its meeting on 22 September 2022, the General Board of the European Systemic Risk Board (ESRB) pointed to the need for credit institutions to implement sound provisioning practices and capital planning and for EU and Member State supervisory authorities to monitor and address vulnerabilities, in close collaboration with each other and availing themselves of the full range of micro- and macroprudential tools. Since the ESRB issued its warning, very few of the identified risks have materialised, but the financial stability outlook is still uncertain and the warning remains relevant.

Over the period 2022-2023, the ESRB also adopted three recommendations on medium-term vulnerabilities in the residential real estate sectors of some countries, along with a general recommendation, adopted in late 2022, on vulnerabilities in the commercial real estate sector in the European Economic Area.

The ESRB has arguably acted in an overarching, proactive and pre-emptive manner, within its mandate, in response to an environment marked by extraordinary uncertainty. In terms

of delivering on its mandate, the current ESRB organisational model has proved equal to the challenge.

Turning to the broader issue of the sufficiency of the macroprudential framework in Europe, one aspect that stands out is the asymmetry in the tools available for banks and for non-bank financial intermediaries (NBFIs). The importance of NBFIs, from the perspective of systemic risk, has grown significantly since the GFC. As the ESRB warning also points out, prudential authorities must ensure they have the right macroprudential toolkit for each sector.

The recent period has been shaped by significant exogenous shocks to the financial system (e.g. the COVID-19 pandemic and the war in Ukraine). These have brought to the fore the discussion of whether to increase “macroprudential space” even beyond what would be necessary to address homegrown financial imbalances. It is argued that this could be achieved via a “positive neutral” countercyclical capital buffer (CCyB) rate, one that would be activated not only in times of excessive credit growth but also in normal times. Still work to do about the coordination of the conditions under which activation or release would take place. So far, activation of the CCyB rate is evaluated and determined nationally, but the ESRB can certainly play a helpful role by supporting and complementing the technical work undertaken by national authorities and acting as a hub for sharing experiences and identifying best practices.

In the current uncertain context, it is necessary to have sound provisioning and capital practices.

Finally, the build-up of risks in the real estate sectors of several EU countries also prompted the ESRB to recommend the development of common European standards for borrower-based measures. These macroprudential tools, available under the national regulations of most countries, help to bolster bank customer resilience and banks.

We need to consider whether common European criteria should be established for the design of such macroprudential tools, including to determine when and how they can be used.



TANATE PHUTRAKUL

Chief Financial Officer - ING Group

Let's cherish consistency and predictability as basis for our welfare

As a CFO thinking about the outlook, I monitor possible financial clouds that could be coming our way. Clouds can consist of interest rates, inflation and economic growth, but also of public policy, regulation and supervision.

NBFI: regulate in a targeted, efficient and effective way

One area where regulators have been very consistent, is in their increasing attention to non-bank financial intermediation (NBFI). This sector's role is easily underestimated. Compared to the US, the Eurozone is a bank-financed economy. Indeed banks are Europe's most important lenders and originators. Still, even in the Eurozone, almost half (48%) of business debt (loans and bonds) is held by non-banks. Even more striking: of the net business debt growth since 2008 in the Eurozone, 82% was funded by non-banks. So it is safe to say that NBFI play a crucial role in funding the economy in the Eurozone.

Yet, financial supervision, prudential in particular, remains focused on banks. Policymakers and supervisors build on what is already there, and the regulatory framework for banks is much more developed. Moreover, consistent regulation of a diverse sector like NBFI is complex.

So when thinking about NBFI regulation, the initial response by some is to regulate banks' exposure to NBFI. Indeed spillovers should be contained by limiting concentration risks. But banks should not be tasked with policing the NBFI sector like gatekeepers. This is undesirable, because banks often have bidirectional client relationships with NBFI and may compete in funding supply or demand. It is also untenable, because almost half of business debt is already held by NBFI, and NBFI are not necessarily depending on banks to get their funding. In fact, the desire to make the Eurozone less bank dependent, also entails further growing the NBFI sector and developing its bank-independent funding channels. This is part of the Capital Markets Union agenda, which deserves new momentum given the "twin transition" financing challenges Europe faces.

Cherish stability and predictability of our institutions

At a more fundamental level, the economic success and welfare we have achieved in Europe is in no small part a result of the solidity of our institutions and the predictability of public policy. I have confidence that such achievements are deep-rooted. Yet in banking, we have recently been confronted with several ad hoc policy measures. I am thinking about e.g. bank taxes that have been created or increased in response to recovering bank profitability in several countries. Policymakers sometimes admit that these taxes are merely the easiest way to plug budget holes, rather than that they serve a consistent, long-term policy goal. I am also thinking about governments

competing with banks' savings accounts by issuing bonds to retail investors, facilitated by ad hoc favourable tax treatment.

Even central banks, bastions of stability and predictability, are sometimes resorting to short term policy responses. Banks were taken by surprise by the unilateral change to TLTRO terms in 2022. The adjustment to the minimum reserve remuneration in 2023 equally caught banks off guard. An increase in the minimum reserve requirement (MRR), currently considered by the Eurosystem, would not help to achieve monetary goals. Moreover, it would set the Eurosystem apart from the Fed, the Bank of England and all other major central banks, that have abolished the MRR altogether, given the availability of other policy tools serving the same purpose of prudential liquidity management in a much better way.

Ad hoc policies, while understandable, hurt predictability, consistency, and reliability of policy.

The ad hoc nature of policy measures, be they taken by governments, central banks or supervisors, is quite understandable in the context of unprecedentedly rapid change in economic, monetary and fiscal circumstances, a society under pressure and severely limited room for manoeuvre. Yet it should also be noted that ad hoc policies do diminish predictability, consistency, and reliability of policy. And this is not just a bank shareholder issue. It is much broader.

We should not underestimate the importance of predictability and stability, the fundamental role they have as bedrock on which Europe's business, including banks, thrive, today and in the future.

Nurturing the good, while regulating the bad out of existence is a challenge. Even more so in an EU that is facing a in many ways challenging environment. But it is a challenge we must rise to, to preserve what has brought us prosperity, grow what is needed to finance the future, all while keeping the financial system safe.



MASAMICHI KONO

Senior Advisor - MUFG Bank, Ltd, Member of the Global Advisory Board, Mitsubishi UFJ Financial Group & Trustee - IFRS Foundation

The impact of faster changes for financial stability

The regulatory and supervisory response to the markets turmoil of March 2023, the collapse of SVB and other US banks, and the acquisition of Credit Suisse (CS) by UBS have proven that regulation and supervision of banks have come a very long way to ensure financial stability. The agreed Basel framework will fortify financial stability, and MUFG supports its timely and consistent implementation. It is of utmost importance for banks operating globally to have a consistent and harmonized set of rules in order to avoid as much as possible regulatory fragmentation and regulatory arbitrage because of the different speed of implementation across various jurisdictions.

As lessons learned from the most recent incidents, some improvements could be considered. First, the recent case of SVB, for example, has shown how fast outflows of liquidity could happen compared to the past. The impact of the new technologies on the speed of deposit outflows may warrant careful consideration, although it should not result in an across-the-board tightening of liquidity requirements. One option could be introducing stress tests that would reflect the characteristics of individual banks. A second possible element could be an improvement in managing the IRRBB. While a one-size-fits-all treatment should be avoided, there may be room for improvement in the identification and implementation of outliers.

We welcome the careful examination by the Basel Committee in this area. On AT1 bonds, we underline their importance in terms of capital requirements, but reviewing investor suitability rules may also be a point for consideration and ensuring clear communication towards investors is key. Of note, market uptake in Japan has been strong even after the CS case. Supervisors should also be able to assess and check bank's funding ability with a held-to-maturity-portfolio.

Another key element to consider in 2024 is the monitoring of developments in the non-bank financial intermediaries (NBFIs) sector. Over the last few years, the importance of NBFIs has increased visibly. Their increased market presence and their level of leverage has raised several concerns among supervisors and policy makers. In 2023, financial regulators and supervisors in EMEA and at the global level have intensified their warnings in relation to exposures of banks to lightly-regulated non-banks which could become threats to financial stability. In particular, the FSB and IOSCO have indicated NBFIs risk as a top priority for 2024 and are expected to design policy recommendations by the end of the year.

The industry recognizes the need to ensure financial stability by supervisors but it is important to recognize the benefits such as diversification and business opportunities that NBFIs could bring to the financial ecosystem. It is therefore important that any regulatory efforts strike the right balance

between those potential benefits and risks. Any initiatives and proposal for changing the current framework for the non-bank financial sector should be proportionate and carefully crafted. To maintain a level-playing field, it would be appropriate to adopt an activities-based approach to non-bank risks, rather than an entities-based approach where appropriate. As of now, regulated banks find themselves at a certain disadvantage against non-banks that provide essentially the same services at much lower regulatory cost.

Among other emerging risks, I would like in particular to highlight the risks from climate change and from digital transformation. On climate change and the transition to net-zero, MUFG is at the forefront of action towards net-zero. Risk management would focus on the identification of the physical and transition climate risk affecting banks, but should also closely work with clients so that the whole economy and society could transition in an orderly and just manner.

Increased uncertainty and new risks demands "agility" as bank's key feature for success.

Consistent and comparable sustainability disclosure standards applied globally are also a key element, and the work of the ISSB on this is crucial. Local standards need to be interoperable with the ISSB standards. On digital, it is important for banks to invest more in their transformation, especially in the areas of new technologies such as generative AI, while maintaining the viability and soundness of their businesses.

2024 will be a year of increased geopolitical uncertainty with several key elections, the military conflicts that continue in several areas of the world and with the expectations of changes in central banks' monetary policy directions resulting in a highly uncertain business environment. Increased agility for financial services providers will become more and more important for success.