ESRB
European Systemic Risk Board
European System of Financial Supervision

Can we achieve and maintain financial stability in a volatile and inflationary environment?

7th Biennial ESE Conference
Berlin, 2023
Crisis! – The new normal for the financial system?

17/10/2023

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Disclaimer

- *The views expressed in this presentation are exclusively attributable to the author and may not necessarily represent the official views of the European Systemic Risk Board*

My mission today

- Many thanks to ESE and BaFin for the invitation.
- You asked me to answer to the question: *Can we achieve and maintain financial stability in a volatile and inflationary environment?*
- And this is a part of a conference which you have entitled *Crisis! – The new normal for the financial system?*

A highly pertinent set of questions

Indeed, we are in a very volatile world.

Simply think of what has been happening over the last two weeks:

- an unprecedented institutional crisis in the US Congress, which must be read in the perspective of the forthcoming presidential elections;
- a tragic terrorist attack against Israel, which triggered a new war and revives an age of heightened uncertainty in the Middle-East at large;
- and – in between – a large sell-off of some of the most relevant world safe assets, which what many market commentators have called ‘a global bond rout’.

These news shocks are aggravating existing challenges (Ukraine war, climate change, higher inflation, receding growth, vulnerabilities in the commercial and real estate sector, etc…).

My perspective

- In order to answer to the question you have raised, I will reason about my experience as Head of the ESRB Secretariat as from 2011 to date.
- I will focus first on how the spectrum of systemic vulnerabilities has developed.
- I will ask myself how institutions have reacted.
- I will then identify two areas where we could improve risk detection and mitigation.
- And I will draw some conclusions.

The European Systemic Risk Board …

- The ESRB is a body of the EU, established in November 2010 in response to the Great Financial Crisis of 2007-2008.
- Its institutional goal is to ‘*contribute to the prevention or mitigation of systemic risks to financial stability in the European Union*’ and ‘*avoid periods of widespread financial distress*’.
- To this end, the ESRB is responsible for the macro-prudential oversight of the financial system within the European Union.

… as an alliance between micro and macro

- The EU legislation also clarifies that the task of preserving financial stability is a collective endeavour. The ESRB is part of the European System of Financial Supervision (ESFS), whose purpose is '*to ensure the supervision of the EU financial system*.'
- The ESFS includes the three European Supervisory Authorities (EBA, EIOPA and ESMA), the ESRB and the national supervisors.
- In other words, the legislation calls for an alliance between micro and macro, and between European and national institutions.

The expectations in November 2010 …

- When the ESRB was created in November 2010, the three main questions were:
  - How to recognise the sources of a new systemic financial crisis, after the one which had shaken the economy in 2007-2008?
  - How to preventively enhance the resilience of the financial sector to the materialization of such a systemic crisis?
  - How to monitor vulnerabilities and crisis triggers in order either to prevent a crisis from happening in the first place, or reduce its length and severity, or to mitigate its consequences?

- All in all, the hope in November 2010 was that systemic crises would have been infrequent and exceptional (perhaps, only one per 1-2 generations) to the point that issuing warnings and recommendations would have given other policy makers sufficient lead-time to avoid or mitigate a crisis.

… had to be first weighted against complexity …

- We discovered soon that the concept of financial stability is complex. Systemic threats include cyclical and more structural vulnerabilities.

  – Excessive credit growth and leverage
  – Excessive maturity mismatch and market illiquidity
  – Direct and indirect exposure concentration
  – Misaligned incentives and moral hazard
  – Resilience of financial infrastructure

…and then with a multiplicity of diverse challenges …

- The decade after the establishment of the ESRB has seen a multiplicity of challenges:

  – How to stabilise Europe's economy after the sovereign debt crises of 2009-2011 (in part originated by the financial sector and in part by fiscal fragility) threatened the very survival of the euro area?
  – How to strengthen a banking sector that had been unprofitable for years?
  – How to avoid that the low-for-longer interest rate environment would feed unsustainable financial bubbles, for instance in real estate?

… which seem to emerge ever more suddenly.

New issues

– How to ensure that the growth of new financial market segments outside banking, the spreading of new technologies (high frequency trading, digitalization, cyber, crypto, artificial intelligence) would create new systemic threats?
– How to react to exogenous developments affecting the financial sector (Brexit, Covid, Ukraine war, geopolitical tensions, climate change)?
– How to cope with higher inflation and how to avoid that a rapid transition to a new ‘higher-for-longer’ interest rate environment would produce market dislocations?

How did policy makers respond?

- Central clearing obligation as part of EMIR since 2012 (with several updates, including post-Brexit).
- Updated regulatory framework for banking since 2013 (CRD IV, including macroprudential policy tools, like the countercyclical capital buffer and the systemic risk buffer; CRR, BRRD). Further upgrade in 2019. Ongoing review to fully implement Basel III.
- Solvency II since 2016 (with some macroprudential tools being hopefully included as part of Solvency II review).
- ESRB review in 2019.
- Update of investment fund legislation (UCITs and AIFMD) with macroprudential aspects being currently finalised.

What structural issues did policy makers encounter?

- Inaction bias, since short-term costs are more visible than long-term benefits (for instance, limited use of the CCyB).
- Often, regulation lags the emergence of new risks: legislative approval and subsequent implementation (passing EU legislation and implementing it normally lasts 5 years).
- Complexity of risks and scarcity of resources to cope with new challenges have become more prominent (e.g. climate change, cyber, crypto).
- Last but not least, financial sector has a great capacity to resist regulatory reforms, push back against supervisory action and lobby political system (e.g. opposition to dividend restraints).

How to improve risk detection and mitigation?

- A – Implementing a new approach to data.
- B – Crosschecking micro- and macro evidence.

Implementing a new approach to data

- Processing data in an enhanced way opens new horizons - role of granular transactional data to understand business models, market dynamics and identify sources of interconnectedness.
- Data quality is a proxy of good governance, effective risk management and attention to detail. Reflecting this, poor data quality can create reputational damage to firms.

How a new approach to data can serve the common mission of micro and macro authorities

- A few examples:

  - Dynamics of market liquidity squeezes (e.g. energy crisis, 2022).
  - Dynamics of speculative attacks in CDS markets (e.g. Deutsche Bank, 2023).
  - Dynamics of market contagion (e.g. Archegos, 2021).
  - Analysis of clearing members' default (e.g. NASDAQ, 2018).

Data - Dos and don’ts

- Combine transaction level data with market intelligence and supervisory activity
- Present your evidence to supervised entities, both to get their feedback as well as to facilitate their awareness of the ecosystem in which they play.
- Accept you may be wrong: understanding granular data in full is a gradual process based on trial and error.

Cross-referencing micro and macro evidence - 1

- Macro-evidence is about systemic risks which companies cannot easily diversify, i.e. they can diversify only at a high cost or at a high risk: whilst segments of the financial sector have different business models, and countries may be in different cyclical positions, large systemic macro swings would affect all of them in one way or another.
- Micro-evidence is about the different capacity of undertakings to take, manage, amplify or absorb risks based on their individual business models, and their specific strengths and weaknesses.

Cross-referencing micro and macro evidence - 2

- Micro and macro are at the same time interrelated and autonomous, offering an individual and system-wide perspective of the financial sector’s resilience.

- A strong macro framework protects, but cannot prevent per se the insolvency of individual systemic institutions (nor should it do it at all costs, as resolution may well be part of the solution).

- The strength of individual companies is the first line of defence, but cannot prevent per se the materialisation of systemic risk.

How cross-referencing micro and macro evidence can serve the common mission of mitigating risk

- Assessing latent micro losses depending upon the materialisation of non easily diversifiable risks due to macro developments (e.g. the transition from low-for-long to higher-for-longer).
- Assessing resilience of stakeholders (e.g. in real estate: banks, promoters, construction companies, property owners – companies and households) to general cyclical and structural factors affecting residential real estate.
- Assessing potential costs to financial companies of adverse developments in governments' fiscal positions (including sovereign debt).
- Assessing potential costs to financial companies of both costly short-term disruption and long-term trends in global supply chains (including de-globalisation).

Cross-referencing micro and macro evidence – Dos and don’ts

- Use ‘top-down stress testing’ as a tool to question the results of bottom-up evidence from supervisory activities.
- Use ‘system-wide stress testing’ to consider the vulnerability of individual firms to the economy.
- Explore ‘reverse stress testing’ to test when failures would occur.
- Do not consider any type of stress test as equivalent to a forecast.

To draw a final assessment: Some final discomforting thoughts…

- There are obvious limits to identifying and mitigating risks, in particular those having the worst impact on the economy.
- Are we getting close enough to achieving ‘sufficient resilience’?
- I often look at these issues with a sense of modesty on what we can do.

… and comforting factors.

- Is our world really exposed to radical uncertainty on an unprecedented scale? Or would any previous generation have had the same feeling of radical uncertainty about the future?
- I was born in April 1963, a few months before John F. Kennedy’s assassination. Even if I was born premature, during the pregnancy my parents experienced the Cuban missile crisis in October 1962. And when they met in 1961, the Berlin Wall was being built. During my youth, I experienced as a youngster and adolescent the age of domestic and international terrorism, oil shocks and high inflation, the fall of democracy in Chile (1973) and the Islamic Revolution in Iran (1979) as well as the threat of a nuclear war in the early 1980s.

Coming back to the starting question

- Can we achieve and maintain financial stability in a volatile and inflationary environment?
- We certainly have a duty to try.