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The ESRB at work – its role, organisation and functioning

Frank Dierick, Petra Lennartsdotter and Paola Del Favero[*+]

A key response of the European Union (EU) to the financial crisis that erupted in 2008 was the establishment of the European Systemic Risk Board (ESRB). The ESRB is an independent body responsible for the macro-prudential oversight of the EU's financial system. Its aim is to identify and mitigate risks that may threaten the stability of the financial system and could damage the real economy. As a response to potential systemic risks, the ESRB may issue warnings and recommendations on how to mitigate those risks. The ESRB brings together all the central banks and financial supervisors of the EU, the European Commission and the Economic and Financial Committee, as well as the three European Supervisory Authorities (ESAs) involved in financial regulation and supervision. This is key to achieving the ESRB's broader, systemic perspective and makes it a unique forum for discussing financial stability issues in a European context.

Keywords: European Systemic Risk Board, ESRB, financial stability, systemic risk, macro-prudential supervision

1 INTRODUCTION

The European Systemic Risk Board (ESRB) was established at the end of 2010 as part of a wider reform aiming to improve financial supervision in the EU. Within this new oversight architecture, the micro-prudential and macro-prudential dimensions represent the two complementary pillars of the European System of Financial Supervision (ESFS). This Commentary portrays the role, organisation and functioning of the ESRB – the macroprudential pillar of the ESFS – a year into its existence. It opens by examining the reasons for setting up the ESRB and its major tasks. It then turns to the institutional set-up and the processes underlying the ESRB's work and decisions. Finally, it reviews the work carried out by the ESRB in its first year.

* ESRB Secretariat.

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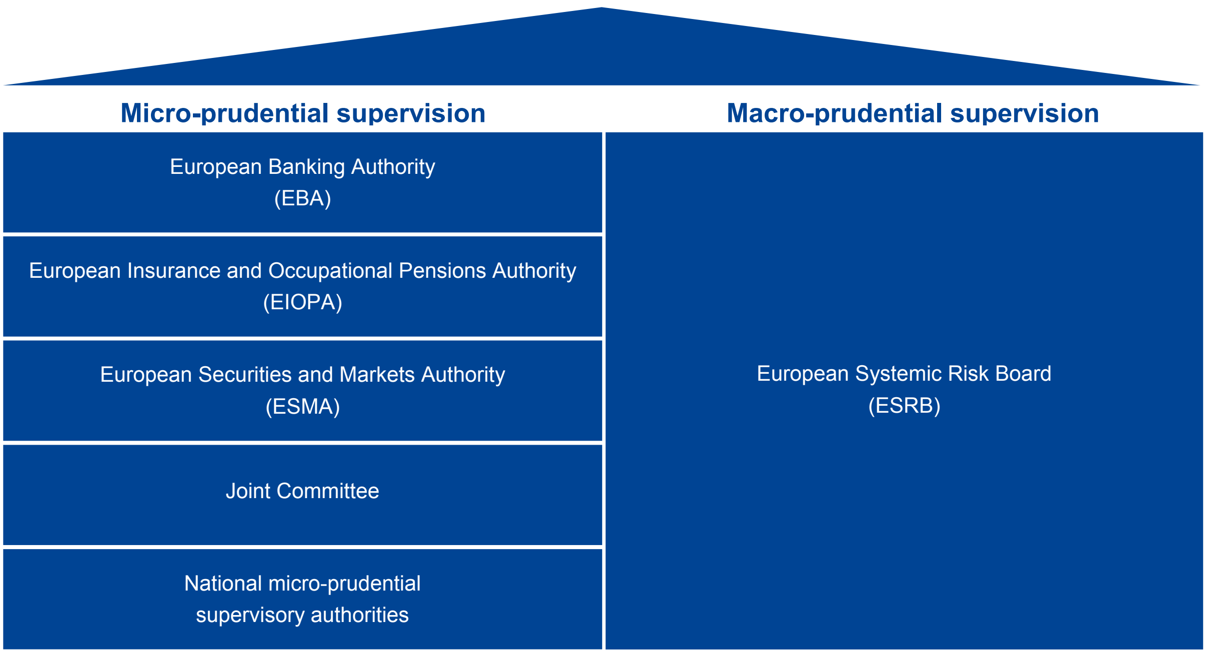
2 BACKGROUND

The global financial crisis that erupted in 2008 revealed serious flaws in the regulatory and supervisory framework[1]. One of the major weaknesses revealed by the crisis was that various financial supervisors had the sole objective of safeguarding the soundness of specific elements of the financial system, such as individual institutions or markets under their remit, referred to as **micro-prudential supervision**. But insufficient attention was paid to assessing the health of the financial system as a whole, i.e. **macro-prudential supervision**.

Macro-prudential supervision focuses on potential disruptions in the financial system or **systemic risk**. The recent financial crisis has shown that just because the individual components of the financial system seem sound, this does not necessarily mean that the financial system as a whole is sound. For example, when one or a few banks have a large loan concentration on a given economic sector, this may not raise any particular concerns, provided that these banks have adequate financial buffers. However, when such risk concentration occurs for the whole banking sector, this may create imbalances and pose a threat to **financial stability**.

To address these shortcomings, the President of the European Commission mandated a group of experts, chaired by Jacques de Larosière, former Governor of the Banque de France and managing director of the IMF, to give advice on the future of European financial regulation and supervision. Based on the resulting de Larosière Report, a new European supervisory structure based on two pillars was set up (see Figure 1).

Figure 1: The European System of Financial Supervision (ESFS)



[1] See, for example, *Report on Enhancing Market and Institutional Resilience*, Financial Stability Forum, April 2008; *Action plan for Recovery and Reform*, G20, April 2009; *Central banking lessons from the crisis*, International Monetary Fund, May 2010; *Lessons of the financial crisis for future regulation of financial institutions and markets and for liquidity management*, International Monetary Fund, February 2009.

Under the **first pillar**, the committees of micro-prudential supervisors that already existed at the European level were strengthened and transformed into the three European Supervisory Authorities (ESAs), namely the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). A Joint Committee of the ESAs was also set up as a permanent forum for cooperation on cross-sectoral issues. Under the **second pillar**, a framework for macro-prudential oversight at the EU level was set up under a new and unique body: the European Systemic Risk Board (ESRB).

The aim of the ESRB is to contribute to the prevention and mitigation of systemic risks to the EU's financial system, i.e. to safeguard financial stability (see Box 1). Comparable macro-prudential bodies were also established in some Member States at national level, as well as outside the EU, at more or less the same time, a prominent example of the latter being the Financial Stability Oversight Council (FSOC), which was set up in the United States under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

BOX 1: KEY CONCEPTS

- **Objectives of macro-prudential oversight.** The ESRB shall be responsible for macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the EU… (ESRB legislation)
- **Systemic risk**. The risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy (ESRB legislation)
- **Financial stability**. A condition in which the financial system is capable of withstanding shocks and the unravelling of financial imbalances. This mitigates the likelihood of disruptions in the financial intermediation process that are severe enough to significantly impair the allocation of savings to profitable investment opportunities (Financial Stability Review of the ECB).
- **Financial system**: In general terms, the financial system includes all financial institutions (e.g. banks and insurance companies), markets, products and market infrastructure (e.g. payment systems, central securities depositories and central counterparties).

The two pillars of the new supervisory architecture should not be seen in isolation; in fact, they operate in **close interaction**. Macro-prudential oversight is not really meaningful unless it can somehow have an effect on supervision at the micro level, while micro-prudential supervision cannot effectively safeguard financial stability without taking into account developments at the macro level. Close interaction is ensured by cross-membership among the four bodies. In addition, several institutions that are members of the ESRB also participate in one or more ESAs. At the operational level, arrangements are in place to ensure the necessary information flow and coordination between the two pillars. For example, in order to carry out its risk monitoring and risk assessment, the ESRB needs to have access to certain data or information only available to the ESAs. Also, in carrying out their micro-prudential tasks, the ESAs need to take into account the ESRB's macro-prudential view of the entire system and in particular the ESRB's warnings and recommendations.

3 TASKS

In pursuing its macro-prudential mandate, the ESRB performs a number of key activities, namely risk monitoring, risk assessment and, if deemed appropriate, the adoption of a policy response. Under **risk monitoring**, information is gathered and analysed, for example through the use of financial stability indicators or early warning indicators. Under **risk assessment**, the most relevant risks are identified and prioritised by assessing the potential implications of their crystallisation using judgment and, where available, analytical techniques such as network analysis and stress testing. Finally, as a **policy response** to the risk analysis, the ESRB may adopt warnings and recommendations.

The ESRB has two instruments to carry out its mandate, namely **warnings** and **recommendations**. The difference between them is that warnings call for the attention of the addressees to identified systemic risks, without a detailed description of the actions required, whereas recommendations include advice on policy actions to be taken to mitigate the identified risks. Addressees of the ESRB's warnings and recommendations can be the European Union, individual EU Member States and the three ESAs, as well as national supervisory authorities in the EU. Recommendations may also be addressed to the European Commission in respect of the relevant EU legislation. Warnings and recommendations can either be confidential, and thus communicated only to the targeted addressees, or they can be public.

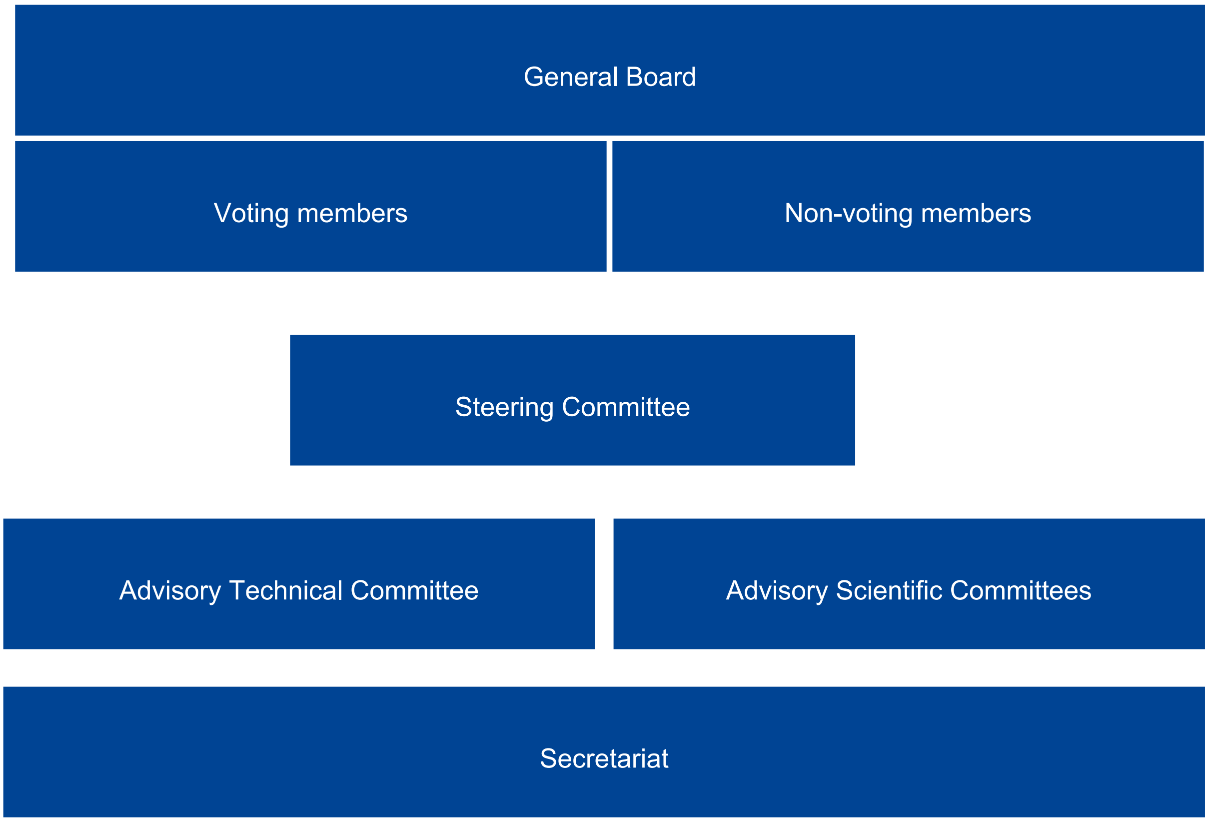
Although ESRB recommendations are not legally binding, the addressees are subject to an "act or explain" mechanism. This means that the addressees have to report to the ESRB on the actions taken to comply with the recommendation or to explain why they have chosen not to. Given the ESRB's composition (detailed below), the process leading to the adoption of warnings and recommendations and their communication involves collective consideration by a set of important bodies and institutions, which makes it difficult for the addressees to simply ignore them. If the ESRB decides to publish a warning or recommendation, this is likely to put additional pressure on the addressees.

4 INSTITUTIONAL SET-UP

A key challenge for the ESRB in performing its task of overseeing systemic risk – but part of its added value in the new supervisory architecture – is to develop a macro-prudential perspective whilst taking into account supervision at the micro level. This is reflected in the composition of the ESRB's **General Board** (see Figure 2), which brings together the central bank governors and high-level representatives of the financial supervisory authorities from all 27 EU Member States, as well as the President and Vice-President of the European Central Bank (ECB), a member of the European Commission and the chairs of three ESAs. To ensure a link with the ministries of finance, the President of the Economic and Financial Committee (EFC) is also a member.

The General Board is the decision-making body of the ESRB. It consists of 65 members – 37 voting and 28 non-voting – and is chaired by the President of the ECB. The voting members are mainly made up of the central bank and ESA members. Decisions are adopted by majority voting, with each voting member having one vote. The fact that ESRB decision-making is based on majority voting rather than consensus is meant to avoid one or a few members blocking a decision.

Figure 2: Organisation of the ESRB



The General Board's broad membership requires efficient preparation of its discussions and decision-making. A smaller **Steering Committee** of 14 General Board members therefore assists the General Board by preparing its meetings and monitoring ongoing work.

Two advisory bodies – the Advisory Technical Committee and the Advisory Scientific Committee – provide advice and assistance at the request of the Chair of the ESRB. The **Advisory Technical Committee** (ATC) has a very similar composition to the General Board. However, whereas the latter is composed of the governors of the central banks and high-level representatives of the national supervisory authorities, members of the ATC are typically at the level of the head of the financial stability department or the head of the supervisory department. The **Advisory Scientific Committee** (ASC) is a smaller body consisting mainly of independent academics with a research background in financial sector issues. The ASC was introduced in the ESRB legislation at the initiative of the European Parliament with the aim of introducing a voice from outside the circle of central banks and supervisors to the ESRB, thereby enriching the financial stability debate. Two key challenges identified by the Chair and the Vice-Chairs of the ASC during the first year of ESRB's operation are set out in Box 2 below.

BOX 2: AN INPUT FROM THE ADVISORY SCIENTIFIC COMMITTEE

The Chair and the two Vice-Chairs of the ASC of the ESRB (Professors Martin Hellwig, Marco Pagano and André Sapir) would like to raise a number of longer-term issues.

Availability of data

One of the tasks of the ESRB is to develop concepts and tools for identifying systemic risk. This requires empirical analysis in order to identify the channels for contagion and the build-up of systemic risk. To achieve this, the ESRB needs adequate and sufficiently granular data; aggregate data are likely to be insufficient. While some systemic risks can be identified on the basis of aggregated data, others cannot. For sensitive individual data, methods developed in other research fields to anonymise individual data while preserving their usefulness for research could be adapted to the ESRB context if needed. Sometimes, however, anonymised data are not sufficient (e.g. when identifying the build-up of systemic risk over time). To handle this, the ESRB, ESAs and national supervisory authorities should work together to monitor systemic risk emanating from individual institutions and the nexus of contracts through which they are connected to the rest of the financial system.

Timing

The quarterly cycle of meetings between the General Board, Steering Committee, ATC and ASC is appropriate for dealing with long-term structural issues, but may be problematic in times of crisis. The legislation does not distinguish between long-term developments where systemic risks build up slowly and short-term crisis developments that occur on a very different time scale. It is therefore important that the ESRB develops a mode of action that is geared towards fast-paced developments.

Finally, the **Secretariat** supports the work of all the above-mentioned bodies. This support includes providing both analytical input and policy advice, as well as support of a more administrative nature. The Secretariat is provided by the ECB: the 20-plus Secretariat staff are located at the ECB's premises and are supported by the ECB's infrastructure. More generally, given its expertise in the area of financial stability, the **ECB** provides a significant contribution to the ESRB and its macro-prudential oversight remit by providing analytical, statistical, administrative and logistical support. Nevertheless, the ESRB and the ECB are institutionally and functionally distinct and independent bodies. The establishment of the ESRB therefore does not have any implications for the mandate of the ECB, in particular as regards monetary policy and price stability.

The ESRB was legally established immediately after the publication of the ESRB legislation in December 2010. It became fully operational when its various bodies were set up in the first half of 2011, and it published its first recommendation in October 2011 (see Box 3).

BOX 3: MILESTONES IN THE ESTABLISHMENT OF THE ESRB

- **February 2009**: Publication of the de Larosière Report
- **September 2009**: Release by the European Commission of its legislative proposals regarding the ESRB and the three ESAs
- **22 September 2010**: Adoption of the legislation by the European Parliament
- **17 November 2010**: Adoption of the legislation by the Council
- **15 December 2010**: Publication of the legislation in the Official Journal of the European Union
- **20 January 2011**: Inaugural meeting of the General Board
- **17 February 2011**: First meeting of the Advisory Technical Committee
- **21 February 2011**: First meeting of the Steering Committee
- **21 June 2011**: First meeting of the Advisory Scientific Committee
- **11 October 2011**: Release of the first public recommendation (on foreign currency lending)
- **16 January 2012**: Release of the public recommendations on the funding of banks in US dollar and on macro-prudential mandates of national authorities.

The Chair of the ESRB has regular hearings at the Committee on Economic and Monetary Affairs of the European Parliament to ensure the accountability and transparency of the ESRB. These hearings are public and can be followed on the ESRB's website (http://www.esrb.europa.eu), where the Chair's introductory statements are also available. The ESRB also reports annually to the European Parliament and the Council; the first annual report is likely to be published in the spring of 2012.

5 WORK DONE SO FAR

In line with its mandate, the ESRB regularly **exchanges views on risks to, and vulnerabilities in, the EU's financial system**. Over the past year, discussions focused on the negative interaction between concerns about the creditworthiness of Member States in the euro area, the increasing difficulty of banks in raising fresh funding, and weakening economic growth. The high integration of the EU's financial system means that its different elements are strongly connected. These strong links easily reinforce financial problems and transmit them across institutions, financial sectors and borders – creating so-called **contagion risk**. At the same time, the ESRB's main role is one of crisis prevention. It is meant to focus on medium and long-term issues and not on emergency policy actions to manage a crisis. In this respect, the fact that the ESRB was set up in a period when a financial crisis had already fully erupted has inevitably complicated the ESRB's policy work in its first year.

Another important area of interest for the ESRB is to develop the basis for macro-prudential policy in the EU. To this end, it has reviewed the **macro-prudential aspects and implications of forthcoming Union legislation**, in particular on capital requirements for credit institutions and on market infrastructure. During the course of 2011 the ESRB wrote to the EU's legislative bodies to emphasise the importance of ensuring that competent national authorities are equipped with broad discretion to take early action at national level, either on their own initiative or on the recommendation of the ESRB. Such action will be necessary to stem the build-up of systemic risk associated with banks in the future, as well as the adverse dynamics of changes in risk management practices by central counterparties (CCPs) that can arise when setting margin and collateral haircut requirements.

The ESRB asked the EU's legislative bodies to take account of its concerns in the course of the legislative process. It is important that, in a single market with a single rulebook, the national macro-prudential authorities are able to tighten the settings of macro-prudential tools above levels provided in Union legislation in response to local financial stability conditions. At the same time, in a single market and in the light of the possible spillover effects across borders, the ESRB can play a key role in ensuring appropriate coordination among national authorities.

Turning to the main policy tools of the ESRB – **warnings and recommendations** – the ESRB has so far adopted three public recommendations (see Table 1). These recommendations, along with the supporting documents examining in depth the issues at hand, are available on the ESRB's website.

Table 1: Public recommendations by the ESRB and their timeline

Subject	Date of adoption	Date of publication	Timeline for follow-up
Lending in foreign currencies	21 September 2011	11 October 2011	31 December 2012 (with other more specific deadlines)
US dollar-denominated funding of credit institutions	22 December 2011	16 January 2012	30 June 2012
Macro-prudential mandate of national authorities	22 December 2011	16 January 2012	30 June 2012 (interim report) and 30 June 2013 (final report)

The first recommendation was on **lending in foreign currencies** to households and small firms which may not have adequate protection against the currency risk that comes with such loans. This type of lending has become common in some Member States in the EU and entails significant risks for the financial sector. Borrowers are exposed to foreign exchange risk, which translates into higher credit risk for the banks that are lending. The banks may also be exposed to higher liquidity and funding risks, for example when they rely on the swap market to fund these loans. Since borrowers typically take on such loans because of their lower interest rate, they may also stimulate excessive credit growth. The ESRB's recommendation aims to tackle the possibility of a further build-up of the above risks by ensuring that new loans in foreign currencies are granted to creditworthy borrowers who understand the associated risk, and that there is appropriate risk management at the institutions that grant the loans.

In its second recommendation, the ESRB addressed the systemic risks stemming from **banks' funding in foreign currencies, in particular in US dollar**. The US dollar is an important funding currency for European banks, and most of this funding is short-term and obtained from other banks and financial institutions. This combination makes US dollar funding volatile, in particular in situations when the fund providers have doubts about the financial health of the banks that are borrowing. Following the eruption of the financial crisis, serious strains in the US dollar funding markets have been observed that could have an adverse systemic impact on European banks' financial health. In order to avoid similar levels of stress in US dollar funding in the future, the ESRB recommended that national supervisors closely monitor banks' funding and liquidity risks in US dollar and limit them if they reach excessive levels. National supervisors should also ensure that banks are prepared for handling shocks in US dollar funding and that banks' contingency planning includes a specific shock to their funding in US dollar.

The third ESRB recommendation deals with the **macro-prudential mandate for national authorities** and provides a set of guiding principles for the macro-prudential frameworks in the EU Member States. Member States are called upon to designate an authority to conduct macro-prudential policy in their legislation, with the aim of safeguarding financial stability. This authority should have sufficient powers to pursue macro-prudential policy and the necessary independence to fulfil its tasks. The central bank should play a leading role in macro-prudential policy. A well-defined national authority with a clear mandate is indeed a necessary condition for effective macro-prudential policy, especially since the ESRB does not have the power to implement macro-prudential instruments directly and can only issue warnings and recommendations that are not legally binding.

The next step after this recommendation is to make the relatively new concept of macro-prudential supervision more precise by designating **macro-prudential instruments**. It is important that national macro-prudential authorities have a range of instruments at their disposal and that evidence on their effectiveness is collected and analysed. Instruments that have been used most frequently for macro-prudential purposes are restrictions on loan-to-value ratios, limits on net open currency positions and caps on debt-to-income ratios. Up to now emerging market economies more than advanced economies like the EU have actively used such macro-prudential instruments.

An important and new macro-prudential instrument that is widely discussed in the context of the new capital requirements framework for credit institutions is the **countercyclical capital buffer**. National authorities will be able to use this tool to build up resilience in the banking system in an economic upswing and to support credit supply in an economic downswing. The use of this instrument can have important cross-border effects, in particular in an integrated financial market like that of the EU. The ESRB is best placed to play a key role in the necessary exchange of information and coordination between authorities to ensure the smooth operation of this instrument in the EU.