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Keynote Address

“It takes all sorts...” - macroprudential oversight in the EU

“It takes all sorts to make a world” is a common expression when confronted with something odd, but at the same time recognizing that diversity is essential. I think it also “takes all sorts”, or at least plenty of different sorts, to make a functional macroprudential body. Especially one at an international level like our host – the European Systemic Risk Board, the ESRB. The ESRB’s macroprudential mandate is mirrored by its broad composition, bringing together central bankers and financial supervisors; national and EU-wide perspectives; sectoral experts and academics. Certainly we may look at various issues differently. We may indeed find each other’s perspectives odd at times. But that is also the point. With the right set-up, differences in perspectives and expertise enrich our assessments and become a strength. And the ESRB uses that strength to handle its rather daunting task of overseeing the EU financial system as a whole. So let me elaborate a little on what the ESRB has achieved so far and why I think the EU needs a strong ESRB with a broad membership as we move forward.

Designed for oversight of a diverse, interconnected financial system

It is quite an impressive journey that the ESRB has undertaken since its launch in 2011. And I am proud to have been along for the ride, not least in my role as Chair of the ESRB’s Advisory Technical Committee. The beginning of the road, in terms of when “a blueprint” of the ESRB reached the public eye, was back in 2009. A high level group chaired by Jacques de Larosière recommended, among other things, that a Union-level body be established with a mandate to oversee risk in the financial system. The aim was to address one of the fatal flaws revealed by the financial crisis – the lack of a truly macroprudential approach for safeguarding the stability of the diverse and interconnected EU financial system.

Before the crisis, the quality of supervision varied substantially between countries, and its coordination within Europe was anything but sufficient. The concepts of macroprudential oversight and policy were largely unheard of and it is probably fair to say that most supervisors (or anyone else for that matter)

could not see the woods for all the trees, let alone knowing how they were connected to the “vegetation” in other countries. Part of the remedy would be an EU body that in a holistic way brings together a representation and expertise as broad as its system encompassing mandate. The ESRB was created more or less on the basis of this blueprint.

Today, almost seven years after the so called De Larosière Report, we have reached a stage where the European Commission is assessing the current macroprudential framework in the Union, including the role of the ESRB. There are a number of areas where the Commission wants to shed some light before drawing final conclusions about possible improvements. One such area is what would be the best composition of the ESRB’s decision making body, the General Board, and also most of its substructures. In this context suggestions to reduce the size of the General Board have been mentioned. This would in my view not only reduce the number of people around the meeting table, but also take away one of the ESRB’s main strengths. As somebody who has seen the ESRB at work from the inside pretty much since it saw the light of day, I wanted to take this opportunity to talk about the experiences so far and how we can use them as we move ahead.

The ESRB brings together “all sorts” within its remit, and voting modalities pave the way for efficient decision making

The ESRB is unique in that it brings together representatives from central banks and financial supervisory authorities from all 28 Member States, representatives from the three European Supervisory Authorities, the ECB, the European Commission and the Economic and Financial Committee as well as the “independent voice” of the ESRB Advisory Scientific Committee, the ASC. As some of you here have experienced in person, the General Board usually has over 70 members seated around the table, most of them central bank governors or heads of national supervisory authorities. Such a crowd around a meeting table could have been a practical nightmare and an impediment to efficient decision-making. But so far it actually works. We have had candid and open discussions in this composition and we have been fully capable of taking decisions. As I touched upon earlier, we may not always unanimously agree on everything, not even after many iterations between the parties involved and at different levels. Such processes may indeed require a bit of patience, especially when a new process is being established. But in the end the arguments from all sides have been heard and when we need to make decisions in the General Board, ultimately we simply vote.

Legally, the ESRB is an independent EU body tasked with macroprudential oversight of the EU financial system and the prevention and mitigation of systemic risk. It is chaired by the President of the ECB. The ESRB has no binding powers but has “soft tools”. To fulfill its mandate, the ESRB identifies, monitors and assesses potential systemic risks and, where appropriate, issues so called warnings, or recommendations to mitigate such risks according to the principle “comply or explain”. This principle simply says that either you do as recommended or you explain why you have chosen not to. Recommendations can be addressed to the EU as a whole, to one or more individual Member States, European Supervisory Authorities, national supervisory authorities, and to the Commission. As I

mentioned, the General Board makes decisions by voting. And several of the votes that have taken place these almost six years have concerned issuing ESRB recommendations.

The ESRB recommendations have contributed to reducing risks in different fields

The very first ESRB recommendation targeted risks generated by lending to EU households in foreign currency, proposing measures to mitigate those risks. Although it is always hard to assess something against a counterfactual, I think it is fair to say that the recommendation in question is likely to have been both timely and important. Mitigating policy actions undertaken by national authorities reduced the risks at hand. If this had not happened, events such as the sharp appreciation of the Swiss franc in 2015 – the Swiss franc being one of the currencies in which the relevant loans were denominated – could have generated severe problems for many EU households. This would in turn have affected other financial and economic developments negatively, with the potential to spread beyond the countries directly affected.

Other recommendations have, much in line with the ESRB's macroprudential mandate, targeted a wide range of issues in different areas such as money market funds; funding of credit institutions; national macroprudential mandates; intermediate objectives and instruments of macroprudential policy; and the assessment of cross-border effects of, and voluntary reciprocity for macroprudential policy measures. Naturally, these policy actions have been underpinned by assessments conducted by specialists with expertise in very different areas, this in cooperation with the broader membership.

Inclusive working methods and broad expertise

I think the ESRB has a good work process in the sense that it combines two features: First, all members are free to send participants to an ESRB workstream. This is an inclusive working method where different perspectives meet, where there is a “buy-in” for the members and where peer pressure is exerted. Second, there is the procedural aspect which I mentioned earlier, that the decision-making body eventually votes on what road to take.

Notably, the ESRB has been able to publish a quite extensive amount of work and has contributed actively to the general debate. This is, in my view, very important for implementing a macroprudential culture in a broader sense, reaching outside the circle of the ESRB membership. Simply by shedding light on some of the macroprudential issues we are dealing with, and explaining why we see a need to tackle them, may contribute to managing expectations; making the job of safeguarding financial stability just a little easier.

The ESRB's contributions also cover very complex, and in some respects sensitive, issues where the parties involved may have started from views that are very far apart from one another. Being capable of getting results even when dealing with difficult tasks like that is an important quality of a body like the ESRB. I should mention that the ASC, with its composition of distinguished academics with different expertise, and in a sense more independent views, has been a catalyst in some of the work I

just mentioned. Some of the topics on which the ESRB has produced and published valuable contributions include, for instance, the regulatory treatment of sovereign exposures; macroprudential assessments of various issues related to shadow banks, an area where there is still a lot of new ground to cover; the insurance sector; and commercial and residential real estate markets in the EU, to name just a few. I am also thinking of the work on structural issues regarding the banking sector, for instance in a report called “Is Europe overbanked?” by the ASC. This is a very relevant question in my view, and one that we will most likely get back to in the first panel today, where the ECB Vice President will lead the panel discussion addressing the effects of the low interest rate environment. The latter is another topic which benefits from being assessed from a macroprudential viewpoint, and which is naturally also on the ESRB’s agenda.

The regular identification and monitoring of potential systemic risks also benefits from the ESRB’s broad composition

I would like to mention another core task for the ESRB, namely identifying potential risks to the EU financial system at an early stage and, as mentioned, issuing warnings or recommendations about policy actions to mitigate such risks when deemed appropriate. Much of the work just mentioned was naturally initiated through the ESRB’s regular discussions on risks and vulnerabilities in the financial system. Here, the ESRB benefits immensely from its broad composition of members, as these tasks must be underpinned by a truly holistic assessment of national, sectoral and overarching aspects, including how all the individual components interact. The ECB’s support on the analytical and the statistical side is, of course, particularly important here, but also the inputs from national authorities and other bodies are essential. We have come a long way in terms of issues such as access to and comparability of data, for instance as regards national banking systems, which is a benefit not only within the ESRB membership. And products like the ESRB Risk Dashboard makes a broad set of risk indicators easily accessible for the Members as well as the general public. Furthermore, the risk discussions often generate further assessments that are eventually communicated in one form or the other, such as the reports and recommendations I just mentioned.

A main strength in the ESRB’s risk assessments is, in my view, that they capture both a top-down perspective on risks as well as national assessments where the members make self-assessments of the risks at hand and what issues they expect to tackle down the road. These assessments are discussed together with all the other inputs to the risk discussions. Moving forward, one area where I hope the ESRB will make further progress is in developing the processes for making country assessments. That would enhance the abilities of the members to exert peer pressure, which may in turn help reduce “inaction bias”.

When it comes to identifying, analysing and monitoring financial stability risks at EU level, many pieces of information are necessary. The processes for handling all the diverse inputs as well as our assessment tools have developed more or less of necessity. To really get the big picture we must understand how the individual pieces connect to each other and we must be able to put them all

together. All in all, I think the ESRB nowadays makes good use of the broad scope of inputs from members with different expertise, connecting all the dots and their inherent dynamics from a truly system-wide point of view.

A new supervisory and regulatory landscape for the EU...

Of course, the ESRB was not the only response to the structural flaws in the supervisory framework which were exposed by the financial crisis. A whole new financial supervisory and regulatory landscape has by now at least roughly found its shape and form in the EU, although there are still some pieces of the puzzle that have not yet fallen into place. I should also say that I do not think that the landscape will ever be completely finalized. That would be a bad idea. These frameworks need to evolve and adjust as we move ahead, as we learn from our experiences and as the financial system which they target is constantly evolving. But I would still say that the rough contours we now have on the map are fairly stable and will stay in place for quite some time. And that is very positive!

Important landmarks in this landscape include, of course, the macroprudential oversight by the ESRB, and the Banking Union which focuses on the euro area. The Banking Union has three pillars; the Single Supervisory Mechanism (SSM) which is a big leap forward on the microsupervisory side; the single resolution mechanism (SRM); and a European Deposit Insurance Scheme (EDIS), which when it is implemented is meant to weaken the link between banks and their national sovereigns and deliver greater trust in the safety of retail bank deposits.

...including national macroprudential frameworks

In addition, national frameworks for macroprudential oversight and policy have been put into place all across the Union. The ESRB has played an important role in that work, not least through its recommendations regarding national macroprudential mandates and intermediate objectives and instruments for macroprudential policy. The latter breaks down the overall objective of macroprudential policy into a number of intermediate objectives, making it more clear what types of risks it is aiming at mitigating. This recommendation also provides an indicative list of instruments that Member States may assign to relevant authorities in order to pursue the objectives of macroprudential policy. The formal recommendations have most certainly been vital in providing a benchmark for the EU Member States when setting up their national macroprudential frameworks. But I also think that the day-to-day work in producing the formal recommendations may have been almost as important. This interaction is, of course, always a key component but especially in this case I think the positive side-effects may have been particularly large. Macroprudential policy was still very much in its infancy at this time and there was a need to find some common language or common ground if one will. I think the work and many discussions at various levels that took place were a catalyst in developing what one could perhaps call a macroprudential culture in the EU.



The introduction of macroprudential instruments

Another landmark, not least in terms of operationalizing macroprudential policy, was passed in 2014 when the Capital Requirements Regulation and Directive, CRR/CRDIV entered into force. The CRR/CRD provided the macroprudential authorities in all EU countries with a set of policy instruments to mitigate financial stability risks in the banking sector more efficiently than the previous toolboxes had allowed for. The ESRB also took on an important role here, in terms of supporting the Member States as they were to operationalize macroprudential policy. In particular, the ESRB produced two reports to this aim: the so called Flagship report, providing an overview of the macroprudential policy framework in the EU banking sector; and a more detailed Handbook which provides assistance for macroprudential authorities on how to use the CRR/CRD instruments for the banking sector. The ESRB also has a formal role in the CRR/CRD, among other things through opining on some national macroprudential measures.

A macroprudential framework extending beyond the banking sector

But the ESRB's macroprudential mandate extends beyond the banking sector, and not every spot on the map over the financial system is as well-known and covered from a macroprudential viewpoint as the EU banks in the remit of the CRR/CRD. The financial landscape is constantly evolving and subsequently the potential sources of systemic risks. One aspect reflecting this is that the share of credit provided by other financial institutions than banks has grown over the past few years. Hence, after making the macroprudential framework for the EU banking sector operational, targeting the parts of the map where we find the non-bank financial institutions, and working on how to provide a holistic view regarding all parts of the financial system, is a natural and important next step.

The ESRB recently published a strategy paper on macroprudential policy "beyond banking", which complements the guidance already provided on the policy framework for the banking sector. That strategy paper is meant to provide a point of reference as we now move on to further enhance the macroprudential policy strategy, regulatory data and instruments for addressing risks in non-bank financial sectors. I should mention that other work related to non-bank financial institutions has also been conducted, where the recently published annual ESRB Shadow Banking Monitor will hopefully provide important insights. The Monitor provides an overview of developments in the shadow banking sector, with focus on assessing potential risks to financial stability. It is intended to foster progress of the debate on related issues and hence targets a broad readership.

The overall mission is to eliminate potential blind spots on the macroprudential map and to connect all the dots. To achieve that, we need both an analytical framework underpinned by sufficiently high quality data, and a policy framework which enables us to target risks in different parts of the financial system in a consistent manner. The resilience of a specific part of the financial system needs to be linked to its potential impact in terms of the systemic risk it could generate for the financial system as a whole. We may also need to develop a wider financial stability toolkit. This would, for instance, include



top-down stress tests for asset managers and central counterparties, and recovery and resolution frameworks for the insurance sector and central counterparties. The ESRB is very well placed to play one of the leading roles here, due to its mandate, the broad expertise of its membership and its inclusive working methods with a wide range of the relevant stakeholders interacting.

The long and winding road from global to national regulation

I have been speaking about CRR/CRD on and off here for the past few minutes, but let me just elaborate a little bit more from another angle. The CRR/CRD started out after a global framework had been agreed in Basel, and this EU level framework was in turn implemented at national level in the Member States. In my day-to-day work I deal with financial stability issues on different levels if one will; As Chair of the Basel Committee for Banking Supervision the scope is global, while as Governor of the Swedish Central Bank I have a national perspective on financial stability although, admittedly, the international agenda and developments play a key role there, too. Being Chair of the Advisory Technical Committee of the ESRB and a member of its decision making body, the General Board, of course provides an EU-level perspective on macroprudential policy and systemic risk. These levels or perspectives are in my view becoming increasingly intertwined, especially after the financial crisis and the lessons learned there.

Much of the agenda is indeed set at the global level first. And the way financial markets function today, this is also quite natural. We need at least minimum requirements at the global level. But we also need to strike a balance between common rules of the game in terms of minimum requirements and the need for national flexibility, not least in the EU, which to put it mildly is far from a homogenous group of countries. In fact, the economic and financial conditions differ substantially between the Member States. While these differences are quite likely to generate different risks, the structure of the national financial system may also in itself contribute to either mitigating or further fuelling them.

One size will not fit all – national flexibility is needed

It is not very long since the CRR/CRD entered into force, but we have already enough practical experience to be thinking about developing it further. In my view, that should include simplifying it. We really had very limited experience of conducting macroprudential policy in practice at the time the CRR/CRD was drafted. In principle, the Commission's starting point was to transform the Basel III minimum capital regulation into a maximum harmonization framework. And the somewhat cumbersome procedures when using some of the instruments under the CRR/CRD are probably the result of the pretty tough negotiations which took place before the current framework saw the light of day. Today, with some more experience and a fair amount of "learning by doing", I think most would agree that national flexibility is necessary for efficient policy implementation.

Furthermore, as I mentioned earlier, the circumstances under which macroprudential policy operates are not static. Therefore, in terms of the macroprudential framework it is unlikely that one size fits all, and fits at all times. Rather, the appropriate macroprudential policy set-up, naturally including the use



of its instruments, will to some extent need to be tailored. The national flexibility, which is already part of the current CRR/CRD framework, is in my view key for efficient macroprudential policies. As we move forward, we may need to strengthen that flexibility even further. We do not have perfect foresight as regards what risks we will have to tackle further down the road. Nor do I think that we will ever develop the perfect tool for every conceivable financial stability risk out there.

One thing to bear in mind in all this, is that whether the perspective is global, regional or national, it all boils down to the same thing - safeguarding the stability of the financial system. And in today's highly interconnected world, it is quite obvious that we to some extent are all in this together. This brings me to a related issue where the ESRB has played a leading role.

Reciprocation of macroprudential measures – key for their effective implementation

An important prerequisite for effective implementation of macroprudential policy in a financially highly integrated world is that the measures in question can affect all financial actors which influence the specific risk that authorities are trying to mitigate. This is not always the case. For example, foreign branches are regulated by authorities in the home country of the parent company, and may not be affected by measures taken in the country where they are active. Reciprocation may in such a situation help mitigate the risks, minimize potential regulatory arbitrage and also provide a level playing field. In 2015 the ESRB issued a recommendation which provides guidance for a systematic assessment of the cross-border effects of macroprudential policy, and a coordinated policy response in terms of voluntary reciprocity for macroprudential policy measures when needed. The recommendation provides the basis for implementing voluntary reciprocity in the EU and sets guidelines for the analysis, notifications and requests to be carried out.

The reciprocity framework is still relatively new but it is a very important part of a macroprudential approach for the reasons just mentioned. I think the ESRB's follow-up assessment of the recommendation in this area will provide important insights on how we might develop this framework further in the future.

The EU needs a strong ESRB as we move ahead

So what about the future role of the ESRB? The financial crisis brought with it new rules of the game for financial markets from a systemic risk perspective. We have a new regulatory landscape and framework for financial supervision, and the ESRB is a pillar in that framework. Not only is the ESRB central in identifying and warning against risks to the EU financial system, and recommending measures to mitigate such risk if needed. It has played a key role by providing a benchmark when the new macroprudential policy frameworks were implemented across the EU. The ESRB continues to be vital in developing that framework further, and with that I mean for both banks and for non-bank financial institutions. There is, of course, also the ESRB's role in the new regulatory framework connected to the CRD/CRR. In addition, I also think that the ESRB more or less by construction is well

placed to help its members tackle mainly national problems, by using peer pressure and working against inaction bias in various ways. This may be very important, not least when vulnerabilities emerge due to problems that are mainly beyond an individual authority's own control. One may wish that we would have come even a little bit further in this area at this point, but it is important to realize that it takes some time to set up the necessary internal framework and processes. But by now the ESRB has that kind of machinery in place. The next step is to start using it.

Even if we have a much more complete supervisory framework in place today, both nationally and at the EU and euro area levels, I think the role for the ESRB as the EU's macroprudential overseer is becoming more and more important. At a high level, there is in particular an increasing need to keep a truly systemic perspective, capturing all financial sectors, their interlinkages and dynamics. The EU banking sector is facing structural problems, non-bank financial institutions are becoming more important, CCPs have taken on a systemically important role and the low interest-rate environment is, among other things, challenging the insurance industry, and the EU financial sector does not seem to become less interconnected. All these issues must be tackled with the impact on the financial system as a whole in mind. And I think the ESRB is key in that endeavour.

For every challenge we face and overcome, we learn. We learn and that makes us better prepared for tackling even more difficult challenges further down the road. That is in my view certainly true for the ESRB. We learned from the financial crisis and there has been a substantial amount of learning by doing since. I must say that the blueprint was good to begin with; pretty much all the necessary nuts and bolts were already in place to create a macroprudential body. Having central banks and supervisors around the same table as European institutions, and not least, adding the independent views of the Advisory Scientific Committee to the mix, is in my view a good set-up. Furthermore, I think that the plan for how all those nuts and bolts and other components should be connected and work together has proven to be a good one too.

While many probably doubted that the ESRB's somewhat complex set-up with so many members could function well in practice, the institution has gone all the way from that original blueprint in 2009 to where it stands today as the EU's macroprudential watchdog. Its machinery brings together all the components that its founding fathers had in mind, with a set-up that has allowed the broad composition and large membership to, in my view, become main strengths rather than impediments. The road we have travelled these almost six years has formed an institution which has developed with the challenges it met. It has fine-tuned its processes and its machinery and I think it is well placed to face challenges today and further down the road.