ESRB
European Systemic Risk Board
European System of Financial Supervision

Closing remarks

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Macroprudential action in an age of radical uncertainty

Keynote speech by Francesco Mazzaferro, Seventh Annual Conference of the European Systemic Risk Board: *Financial stability challenges ahead: emerging risks and regulation*

It has become a tradition and a great honour for me that, in my capacity as Head of the ESRB Secretariat, I am closing the Annual Conference of the European Systemic Risk Board.

As always, I will not try to summarise the rich discussions we had, but rather to draw conclusions from the perspective of where I work and of how I see things myself, i.e. as a practitioner of macroprudential policy. In other words, somebody who – sitting at the meeting point of all work – helps ensure that the key insights are brought to the attention of our policy committees, up to the most senior level.

The ESRB's mission is anchored in its mandate: identifying and helping to prevent or mitigate systemic risk in the European Union or in part of it. I will therefore briefly reflect on what the ESRB did last year. I will then consider how the ESRB Secretariat can further help ensure that the ESRB mandate is properly delivered in an age of what I will call 'radical uncertainty', borrowing the terminology used by John Kay and Mervyn King in their book published in 2020. I will finish with some more structural considerations on the crucial role of data in this context.

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Let me first review where the ESRB has formulated public positions in the interval between this and the previous annual conference, which took place early December 2022. By then, the ESRB had just issued its first General Warning on medium-term risks to financial stability and the economy. The ESRB Chair Christine Lagarde has already discussed it in her Opening Remarks.

In early 2023, the ESRB focused on a sector that has been strongly affected by the pandemic and the structural change it caused, as well as by the rapid rise in interest rates: I am referring to commercial real estate, which presents some systemic risk profiles. The ESRB issued a recommendation to the EU and national authorities on the need to improve the monitoring of systemic risks stemming from commercial real estate. This implies enhancing the supervision not only of banks, but also of other financial institutions, first of all investment funds active in the sector. With the benefit of hindsight, this was a much-needed step, if we consider some of the fallout seen in recent weeks.

In parallel, we also pursued our work on cyber risks and published our assessment of how traditional macroprudential policy tools might help reduce stress, if the propagation of cyberattacks undermined confidence in the financial system. I can testify to the progress which the Joint Committee of the European Supervisory Authorities has achieved over 2023 in the implementation of a previous ESRB recommendation: the build-up of an EU-wide coordination framework to react to systemic cyber incidents, also in line with the implementation of the Digital Operational Resilience Act (DORA). This also proved to be a much-needed and timely step: the exposure to cyber-attacks is considered today by the industry as one of its most acute vulnerabilities. For instance, you have certainly read about the very recent ransom attack on the US-subsidiary of a large Chinese bank, which has threatened disrupting trades in US Treasury market. In these hours, some systemically relevant settlements are performed via USB stick.

In spring we considered crypto assets and decentralized finance. We proposed a framework for standardized reporting and disclosure requirements to identify interactions between the crypto sector and traditional finance. The so-called ‘crypto winter’ of 2022 did not spill over to

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the mainstream financial system. But crypto seems to have bounced back somewhat, and some mainstream financial institutions are keen to develop business based on crypto. Thus, we need to continue watching these developments and stand ready to address risks arising from crypto conglomerates and crypto-based leverage in particular.

In summer we published a report on systemic vulnerabilities in the investment fund sector, focussing on assets that are inherently illiquid such as real estate, and assets that trade in markets that are not reliably liquid such as corporate debt. This publication - which has been the result of many months of work - has been aligned with recent, important legislative progress in the review of the EU prudential regulatory framework for investment funds. The revised directives on ‘Alternative Investment Fund Management’ (AIFMD) and ‘Undertakings for Collective Investment in Transferable Securities’ (UCITs) will soon enshrine new tools in the acquis communautaire to enable fund managers to better manage liquidity in times of stress. The ESRB stands ready to assist ESMA in the phase of development and implementation of the necessary technical standards.

Autumn has started with an increasingly acute awareness of the above-mentioned situation of ‘radical uncertainty’. What philosophers call the ‘human condition’ is very much about not being able to assign precise probabilities to the materialization of risks we are facing in our lives. And yet, calculating such probabilities is at the very heart of our financial system. This is now being tested as we face new and unexpected challenges.

Right now, we are witnessing two wars in close proximity to the European Union. We are seeing climate change accelerating with an increased frequency of natural catastrophes, and we are seeing new technological breakthroughs, notably Artificial Intelligence, with opportunities but also threats that we are unable to fully comprehend. The world keeps surprising us with new potential threats to financial stability.

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This allows me to turn to my second point: the delivery on the ESRB mandate in an age of radical uncertainty. I am optimistic for the use of macroprudential policy. Many of the

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macroprudential tools have been designed with the global financial crisis of 2007-2008 in mind, but they still have a role to play today.

Where does my optimism come from? It stems from the fact that – at the time where more resilience is needed – the financial system in the European Union is already more resilient than in the past and relatively more resilient than in other regions of the world. In other words, if there were the need to make use of macroprudential tools to address new risk in a complex geopolitical environment, this would not hit a weakened financial system with a highly pro-cyclical impact.

Let me short focus on two points: capacity to withstand strained market conditions and regulatory framework.

First, in the episode of instability experienced in spring this year, the EU's financial system appeared resilient. We have not experienced the bank runs like the ones which affected the regional banks of the West Coast of the US, nor the drama of a global systemically important credit institution failing like in Switzerland. The strains in the pension fund sector, which hit UK one year ago, have not crossed the Channel. And the volatility of long-term yields in the US Treasury market has not disrupted government bond markets on this side of the Atlantic. I say this with a great sense of humility; indeed, we should beware of hubris.

Moreover, progress on the regulatory side has continued in the EU, well beyond the above-mentioned progress in the area of investment funds. Microprudential policy – the first line of defence – will further strengthen banks and insurance corporations once Basel 3 will be fully implemented and Solvency II will be upgraded. Finally, the banking sector – with only a few exceptions – has seen much higher levels of profitability, helping to increase capital levels. But there is an area where I feel that financial regulation in the EU is lagging: money market funds have shown to be a vulnerable market segment, and the ESRB has issued two recommendations to address these vulnerabilities over the past decade.

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I would like to conclude with some reflections on data. The ESRB Secretariat hosts some of the largest transaction-based datasets in the world. We have learned to provide the ESRB with detailed analysis of the market microstructure, which is so important to understand how liquidity conditions and risk concentration may exacerbate adverse market dynamics, with potential systemic implications for the economy. For instance, we were able to analyse with a great degree of precision the market dynamics when some Credit Default Swap prices overreacted in the days after the events of March this year in Switzerland.

This illustrates what we can do with good access to data. But we need to go further. So I have three observations on data:

First, while the EU has achieved important progress in providing access to detailed information to micro and macro supervisory institutions, more is needed to facilitate the exchange of data among them. In fact, often access to data is granted by law to one specific category of supervisory authorities only, under the wrong assumption that there would be no rationale for other categories of authorities to analyse them. We need to solve this issue and become more flexible in the way we share data and analyse them jointly in the face of new challenges.

Second, I have already referred to new sources of systemic risk (cyber, climate, crypto), which the ESRB has discussed last year. Anticipating how the financial sector could be hit by developments in these areas, to which I would add geopolitical risks, requires comprehensive access to data. A lot of data are already available to supervisors, so it is a matter of improving data sharing, as just mentioned. Other types of data are not yet available. But significant progress is underway in some areas such as the reporting of cyber incidents. However, we need to be realistic: we will never have all the data we may want to have to prepare for new crisis scenarios. It is therefore important that the ESRB's member institutions be ready to make decisions also in absence of complete information, developing a higher tolerance to uncertainty in decision making whenever the strength of the financial sector is at risk.

Third, our experience with analysing granular data permits us to document pervasive data quality problems. From a regulatory point of view, this is contrary to the aim to create a more transparent financial system, as we intended to do following the global financial crisis. Accurate data are key to the timely identification of ongoing market developments, especially if

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they could lead to significant systemic dislocations. Therefore, poor quality of data should not be seen as a technical issue or simply a sign of insufficient attention to detail. It could also be a symptom of deeper flaws in risk management capabilities in some systemic nodes of our financial system. Looking ahead, the legislator should define clear responsibilities for data quality of the reporting entities and, if needed, enable supervisors to sanction the most serious and persistent failures.

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I should not close this conference without expressing my gratitude: to the speakers and participants at this event for the rich insights and discussions you have brought to this event. I would also like to thank my staff: every merit of our common progress during the last year is mainly the result of my colleagues' work.

I would like to thank, in particular, the members of the management team: my Deputy Tuomas Peltonen, my advisers Emily Beau and Olaf Weeken, as well as the new colleague Ralf Jacob. I am also grateful to Andreas Westphal, who retired recently. Many other colleagues should be named as well, but the list would get too long. Let me mention now Shirley Simmons-Nocca and Elena Lanza, who have been instrumental in preparing this conference.

With this, I declare the Seventh Annual Conference of the European Systemic Risk Board as closed.

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