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I am delighted to present the first Annual Report of the European Systemic Risk Board (ESRB), which was established in December 2010 as an independent body of the European Union (EU) responsible for the macro-prudential oversight of its financial system.

In its first year of existence, the ESRB was confronted with an exceptionally challenging economic and financial environment. To address the range of systemic risks that this entailed, it had to become operational very quickly. For most of its first year, Jean-Claude Trichet was at its helm and I wish to pay tribute to him.

From the start of 2011 the ESRB engaged in a regular review of systemic risks to the EU financial system. A key issue in this respect was the interaction between the creditworthiness of European sovereigns, the increasing difficulty of banks in raising funding, and weakening economic growth. Furthermore, the ESRB adopted three public recommendations on: i) the macro-prudential mandate of national authorities; ii) lending in foreign currencies; and iii) US dollar-denominated funding of credit institutions. It is now working on setting up the relevant follow-up mechanism, in line with the “act or explain” regime. Finally, throughout the year, as part of its work to develop the basis for macro-prudential policy in the EU, the ESRB reviewed the macro-prudential aspects of forthcoming EU legislation – in particular on banks’ capital requirements and on market infrastructure – and shared its macro-prudential concerns with the EU’s legislative bodies.

This report has been prepared in accordance with Article 19 of the ESRB Regulation, which states that "at least annually and more frequently in the event of widespread financial distress, the Chair of the ESRB shall be invited to an annual hearing in the European Parliament, marking the publication of the ESRB’s annual report to the European Parliament and the Council”. I will have the privilege to present this first Annual Report to the Committee on Economic and Monetary Affairs of the European Parliament in a public hearing scheduled for 31 May 2012.

Frankfurt am Main, May 2012

Mario Draghi
ESRB Chair

This is the first Annual Report of the European Systemic Risk Board (ESRB). It has been prepared in accordance with the ESRB Regulation\(^2\). The report is structured as follows: Section 1 outlines the role and functioning of the ESRB; Section 2 provides an overview of the activities carried out by the ESRB since its establishment in December 2010; and Section 3 reports on a number of issues considered by the ESRB during the period under review.

Section 1 begins with an overview of the main steps in the establishment of the ESRB, which culminated in the entering into force of the ESRB Regulation in December 2010. It goes on to describe the main tasks of the ESRB as an independent European Union (EU) body responsible for the macro-prudential oversight of the EU financial system. These tasks include carrying out risk analysis, issuing warnings and recommendations (which can be public or confidential), and monitoring compliance with the latter. Finally, the Section explains the institutional framework of the ESRB, which comprises the General Board, the Steering Committee, the Advisory Scientific Committee (ASC) and the Advisory Technical Committee (ATC). The institutional framework was implemented within a short time frame on the basis of a number of decisions taken at the beginning of 2011.

Section 2 first provides an overview of the ESRB’s work in terms of identifying and assessing risks to the EU financial system. To this end, the General Board regularly exchanges views on systemic risks and carries out in-depth reviews of vulnerabilities within the financial system, with regular contributions from the European Central Bank (ECB), the three European Supervisory Authorities (ESAs), the European Commission, the ASC and the ATC. In 2011 the ESRB dealt with risks stemming from the systemic nature of the crisis, as well as more specific risks that, in a number of cases, led to the issuance of warnings or recommendations. Second, the Section outlines the ESRB’s contribution in 2011 to the establishment of sound macro-prudential frameworks at both the EU and national level. This involved identifying a set of guiding principles that should shape the mandates of the national macro-prudential authorities, as well as providing its views on macro-prudential aspects of selected pieces of draft EU legislation with major implications, in terms of scope of intervention, for macro-prudential oversight in the period ahead. In particular, they included the draft directive and regulation on capital requirements for credit institutions (the CRD/CRR) and the proposal for a regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (EMIR). In its policy messages, the ESRB highlighted the importance of ensuring that the competent national authorities have adequate scope and flexibility to deal with systemic risks. One particular aspect of the CRD/CRR considered by the ESRB was the introduction of the counter-cyclical capital buffer under the Basel III agreement. Third, the Section reports on the ESRB’s work on performing fundamental analysis for macro-prudential oversight and developing analytical tools, with a view to filling knowledge gaps on issues that may relate to the build-up of systemic risks (e.g. the shadow banking sector and the interconnectedness and emergence of new systemic players).

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\(^2\) See Article 19 of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, which states that “at least annually and more frequently in the event of widespread financial distress, the Chair of the ESRB shall be invited to an annual hearing in the European Parliament, marking the publication of the ESRB’s annual report to the European Parliament and the Council”.

Finally, in order to enhance public understanding of macro-prudential oversight, Section 3 explains in a non-technical way a number of issues that the ESRB worked on in 2011. They include: the macro-prudential mandate of national authorities; lending in foreign currencies; US dollar-denominated funding; and the “retailisation” of complex financial products, i.e. the marketing of complex financial products, such as structured products and some complex exchange-traded products, to retail investors by financial institutions.

With regard to the macro-prudential mandate of national authorities, the ESRB’s work led to the adoption of a public recommendation containing a set of “guiding principles” to aid the development of national macro-prudential mandates. Concerning lending in foreign currencies, the ESRB came to the conclusion that high levels of foreign currency lending may have systemic consequences for the countries concerned, as well as entail the potential for cross-border contagion. It therefore decided to issue a public recommendation for remedial action by the relevant authorities. In the case of US dollar-denominated funding, the ESRB considered that action should be taken to avoid a recurrence in the medium term of the strains in US dollar-denominated funding of EU banks observed during the crisis and issued the relevant authorities with recommendations for action. Regarding the retailisation of complex financial products, the ESRB concluded that further work was warranted, particularly with regard to the risk that retailisation could dry up as a source of funding for specific banks. This issue is being examined more closely by a recently established expert group on bank funding.
Section 1
Role and functioning
1.1 The establishment of the ESRB

The European Systemic Risk Board (ESRB) has been responsible for macro-prudential oversight in the European Union (EU) since December 2010. It is tasked with assessing systemic risks to the stability of the EU financial system as a whole. Macro-prudential oversight aims at identifying, preventing and mitigating risks that may have a general impact on the financial system and the economy.

Box 1 provides an overview of the main steps in the establishment of the ESRB, which culminated in the entering into force in December 2010 of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (hereinafter referred to as the “ESRB Regulation”). A similar process on the other side of the Atlantic led to the creation of the Financial Stability Oversight Council (FSOC) under the Dodd-Frank Act, which was signed into law by the President of the United States in July 2010. More recently, macro-prudential bodies have been set up in several countries all over the world, including within the EU.

Box 1
Main steps in the establishment of the ESRB

November 2008: the European Commission tasks a high-level group chaired by Jacques de Larosière to make recommendations on how to strengthen European supervisory arrangements.

February 2009: the de Larosière Report recommends, among other things, the establishment of an EU body to oversee risk in the EU financial system as a whole.

May 2009: the Commission suggests a series of reforms to the current arrangements for safeguarding financial stability within the EU, including the creation of a European Systemic Risk Board that would be responsible for macro-prudential oversight.

June 2009: the ECOFIN Council of 9 June and the European Council of 18-19 June agree with the Commission’s suggestions and welcome its intention to put forward legislative proposals so that the new framework can be implemented in the course of 2010.

September 2009: the Commission adopts legislative proposals regarding the ESRB and the three European Supervisory Authorities (ESAs).

September to November 2010: the legislation is adopted by the European Parliament on 22 September and by the EU Council on 17 November.

The ESRB is part of the European System of Financial Supervision (ESFS), the purpose of which is to ensure the supervision of the EU financial system. The ESFS consists of two pillars, namely macro-prudential oversight and micro-prudential supervision (see Figure 1). Macro-prudential oversight is a complement to micro-prudential supervision. While the objective of macro-prudential oversight is to contribute to safeguarding the stability of the financial system as a whole by strengthening its resilience and reducing the build-up of systemic risks, micro-prudential supervision seeks to ensure the safety and soundness of individual financial institutions. As stated in the de Larosière Report, “macro-prudential supervision cannot be meaningful unless it can somehow impact on supervision at the micro-level; whilst micro-prudential supervision cannot effectively safeguard financial stability without adequately taking account of macro-level developments”.

Macro-prudential oversight is the responsibility of the ESRB and the competent macro-prudential authorities in the EU Member States, while micro-prudential supervision is undertaken by the three ESAs that were established at the same time as the ESRB, i.e. the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), by the Joint Committee of the ESAs and by the competent micro-prudential supervisory authorities in the EU Member States (as specified in the regulations establishing the three ESAs).

The two pillars of the ESFS are closely linked, the importance of which is highlighted by the fact that the ESRB Regulation, pursuant to the principle of sincere cooperation in accordance with Article 4(3) of the Treaty on European Union, explicitly calls upon the parties to the ESFS to cooperate with trust and full mutual respect, in particular to ensure that appropriate and reliable information flows between them.

1.2 The tasks of the ESRB

The ESRB is an independent EU body. According to the ESRB Regulation, “the ESRB shall be responsible for the 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 Union that arise from developments within the financial system and taking into account macroeconomic developments, so as to avoid periods of widespread financial distress. It shall contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth”. To this end, the ESRB’s tasks include the following: i) collecting and analysing all relevant and necessary information; ii) identifying and prioritising systemic risks; and iii) where such systemic risks are deemed to be significant, issuing warnings and recommendations for remedial action.

The set of activities involved in the first two tasks mentioned above can be referred to as “risk analysis”. This includes risk monitoring, in the course of which the ESRB gathers and analyses information, using, for example, financial stability indicators and early warning indicators. It also includes risk assessment, in the course of which the ESRB identifies and prioritises systemic risks by assessing the potential implications of their materialisation through judgement and analytical techniques, such as network analysis and stress testing (which are discussed in more detail in the following sections of this report). These activities require an extensive amount of information, collected in accordance with the relevant provisions stipulated in the ESRB Regulation (see Box 2 for further details).

Box 2

The collection of information by the ESRB

The ESRB Regulation stipulates the collection and analysis of the relevant and necessary information as one of the tasks of the ESRB and establishes the framework for how this is to be done. Reflecting its expertise in financial stability and statistical issues, the European Central Bank (ECB) contributes significantly to this task in line with its mandate to provide analytical and statistical support to the ESRB.1 Sources of information include: i) the ECB and the European System of Central Banks (ESCB); and ii) the ESAs, in accordance with Article 15 of the ESRB Regulation. As a rule, the ESRB requests information in aggregate form (i.e. the individual financial institutions cannot be identified). However, in some cases, information in aggregate form may not be sufficient for the prevention and mitigation of systemic risks. Therefore, it may sometimes be necessary to collect information on individual institutions (firm-specific information). Article 15 of the ESRB Regulation sets out special conditions for this, namely that the “data on the respective individual financial institution is deemed to be systemically relevant and necessary”, and that the request is “justified and proportionate”. The aim is also to avoid a substantial increase in the reporting burden.

Building on these provisions and in order to ensure a strict and transparent confidentiality regime for the exchange of firm-specific information, the ESRB and the ESAs signed an

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1 See Article 2 of Council Regulation (EU) No 1096/2010 of 17 November 2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board.
Based on the information available and following its risk analysis, the ESRB can issue warnings and recommendations. Warnings are intended to draw attention to a systemic risk, while recommendations focus on the policy actions to be carried out in order to mitigate a systemic risk. Such warnings and recommendations may be addressed to the EU as a whole, to one or more of its Member States, to one or more of the ESAs and to one or more of the national supervisory authorities. Recommendations may also be addressed to the European Commission if they concern EU legislation.

Warnings and recommendations can be either public or confidential: in the latter case, they are only communicated to the intended addressees. According to the ESRB Regulation, the ESRB decides on their publication on a case-by-case basis and after having informed the EU Council sufficiently in advance so that it has time to react. In taking such a decision, the ESRB has to strike a delicate balance between the need to be transparent and accountable, and the need to preserve confidentiality (e.g. for financial stability-related reasons). Public disclosure can also help to foster compliance with the recommendation. This is particularly relevant because the powers
Members of the General Board at the inaugural meeting on 20 January 2011

of the ESRB are essentially of a “soft” nature, i.e. its recommendations are not legally binding. The monitoring of compliance with a recommendation is based on an “act or explain” mechanism, whereby the addressees communicate to the ESRB (and to the Council) the actions they have undertaken in response to the recommendation, providing adequate justification for any inaction. If the ESRB considers the addressees’ response inadequate, it informs the addressees, the Council and, where appropriate, the ESA concerned. The European Parliament may also play an important role in this, as, in the case of a public recommendation, it can invite the Chair of the ESRB to explain the decision (the addressees may also request to participate in an exchange of views).

During its first year of work, the ESRB issued three public recommendations on: i) the macro-prudential mandate of national authorities; ii) lending in foreign currencies; and iii) US dollar-denominated funding of credit institutions (see Section 3). As the first deadlines for the addressees to report on the action taken in order to implement the recommendations are in mid-2012, the ESRB is developing a framework for monitoring the implementation of its recommendations. It has already taken initial steps in this process, with the establishment of a follow-up mechanism and the creation of a dedicated space on its website, and further steps will follow.

In order to comply with Article 3(2)(i) of the ESRB Regulation, in 2011 the ESRB also started to foster working relations with international institutions and bodies (such as the International Monetary Fund (IMF), the Financial Stability Board and the Basel Committee on Banking Supervision), as well as with macro-prudential authorities in countries outside the EU, such as the recently established FSOC in the United States.

Finally, as an independent body responsible for the macro-prudential oversight of the EU financial system, the ESRB is accountable to the European Parliament (see Article 19 of the ESRB Regulation). To this end, the Chair of the ESRB is invited regularly to hearings before the Committee on Economic and Monetary Affairs of the European Parliament. These hearings are public and can be followed on the ESRB’s website, where the Chair’s introductory statements are also published. The first such hearing took place on 11 October 2011. Prior to this, on 10 May 2011 the Chair of the Advisory Technical Committee (ATC) had an exchange of views with members of the Committee on Economic and Monetary Affairs of the European Parliament in order to present the work of the ATC.

According to Article 5(4) of the ESRB Regulation, the Chair and the Vice-Chairs are also required to present to the European Parliament, during a public hearing, how they intend to discharge
their duties under the Regulation. The first hearing for the Chair (Jean-Claude Trichet) was held on 7 February 2011 and the first hearings for the Vice-Chairs (Sir Mervyn King and Andrea Enria) were held on 2 May 2011. The hearing for Mario Draghi, who succeeded Jean-Claude Trichet, was held on 16 January 2012.

Under the ESRB Regulation, the ESRB is also expected to report to the European Parliament and the EU Council by producing an annual report, which is to be presented by the Chair of the ESRB at a public hearing before the Committee on Economic and Monetary Affairs of the European Parliament on the day of its publication and simultaneously made available to the public on the ESRB’s website.

In terms of communication, while it was judged premature to launch a flagship publication in addition to an annual report, the ESRB was keen to increase public awareness of systemic risk and macro-prudential oversight. To this end, it launched its website in December 2010 and initiated preparations for a series of commentaries on macro-prudential issues, which are to be published regularly on its website. The first two commentaries, entitled “The ESRB at work – its role, organisation and functioning” and “The macro-prudential mandate of national authorities”, were published in February and March 2012 respectively. The purpose of the macro-prudential commentaries is to provide the general public with focused and concise information. Further commentaries are planned in 2012. The General Board also decided to complement the commentaries with a section in the ESRB’s Annual Report which describes in an accessible manner the issues that the ESRB has been working on (see Section 3).

1.3 The institutional set-up of the ESRB

2011 was the ESRB’s first full year of existence. Having been established during a period of severe financial stress, it was immediately confronted with the need to ensure a regular exchange of views on systemic risks. This meant that the institutional framework had to become operational very quickly, requiring decisions on the actual set-up and functioning of the ESRB, including its mandate and the composition of its bodies and committees, the establishment of its Rules of Procedure and Code of Conduct, and the appointment of a Data Protection Officer.

4 Further information is available on the ESRB’s website at www.esrb.europa.eu
The institutional framework of the ESRB comprises the General Board, the Steering Committee, the Advisory Scientific Committee (ASC), the ATC and a Secretariat, all of which met for the first time in the first half of 2011 (see Box 3 and Figure 2). To ensure a smooth start for the ESRB, a Preparatory Secretariat within the ECB was set up in March 2010. This was then transformed into the ESRB Secretariat on 1 January 2011.5

| Box 3 |
| First meetings of the ESRB’s bodies and committees |
| 20 January 2011: inaugural meeting of the General Board |
| 17 February 2011: first meeting of the ATC |
| 21 February 2011: first meeting of the Steering Committee |
| 18 March 2011: first regular meeting of the General Board |
| 21 June 2011: first meeting of the ASC |

The General Board is the decision-making body of the ESRB and is chaired by the President of the ECB. It has 65 members (37 voting and 28 non-voting). The voting members include: the President and Vice-President of the ECB; the governors of the national central banks (NCBs) of the EU Member States; the Chairs of the three ESAs; a member of the European Commission; the Chair and the two Vice-Chairs of the ASC; and the Chair of the ATC. The non-voting members are: the President of the Economic and Financial Committee and one high-level representative per EU Member State from the competent national supervisory authorities.6 While the size of the ESRB’s membership can pose a logistical challenge at times, it ensures that all the relevant parties are properly involved and that the ESRB’s assessment of systemic risk is based on a wide range of views and a broad set of information.

The current Chair of the ESRB is Mario Draghi, who succeeded Jean-Claude Trichet on 1 November 2011. The President of the ECB is the ex officio Chair of the ESRB for a term of five years from the date of its inception. For subsequent terms, the modalities for appointing the Chair are to be set out in a review to be carried out within three years of the establishment of the ESRB (see Article 20 of the ESRB Regulation). The Chair presides at the meetings of the General Board and the Steering Committee, and represents the ESRB externally.

The first Vice-Chair of the ESRB is Sir Mervyn King, Governor of the Bank of England. He was elected for a term of five years by his fellow members of the General Council of the ECB, taking into account the need for a balanced representation of all EU Member States and the need to ensure a balanced exchange of views between those Member States whose currency is the euro and those whose currency is not the euro. The second Vice-Chair is the Chair of the Joint

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5 The preparatory work for the establishment of the ESRB was conducted in accordance with a master plan consisting of three main strands of work: i) procedures; ii) policies; and iii) infrastructures (including the roll-out of DARWIN (the ECB’s document management system) to more than 1,000 users across the EU).

6 As a rule, the high-level representatives rotate, depending on the agenda for the meeting, unless the national supervisory authorities of a particular Member State have agreed on a common representative.
Committee of the ESAs (in 2011 it was Andrea Enria, Chair of the EBA, and currently it is Steven Maijoor, Chair of the ESMA). The Vice-Chairs, in order of precedence, preside at the meetings of the General Board and the Steering Committee when the Chair is unable to participate.

Given the large membership of the General Board, it is important that its discussions are prepared efficiently. In addition to the Chair and the Secretariat, the Steering Committee plays a key role in this respect. The Steering Committee comprises 14 members of the General Board and is tasked with assisting in the decision-making process of the ESRB by preparing the meetings of the General Board, reviewing the documents to be discussed and monitoring the progress of the ESRB’s ongoing work.

The ESRB can consult its two committees, the ATC and the ASC, which are tasked with providing advice on issues of relevance to the ESRB at the request of the Chair. The ATC is

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7 They are: the Chair and first Vice-Chair of the ESRB; the Vice-President of the ECB; four other members of the General Board, who are also members of the General Council of the ECB (currently Marek Belka, Governor of Narodowy Bank Polski; Ignazio Visco, Governor of the Banca d’Italia; and Jens Weidmann, President of the Deutsche Bundesbank. Athanasios Orphanides, Governor of the Central Bank of Cyprus was a member until 2 May 2012); a Member of the European Commission; the Chairs of the three ESAs; the President of the Economic and Financial Committee; the Chair of the ASC; and the Chair of the ATC.
composed of high-level representatives from the ESRB’s member institutions. They are typically
the head of the financial stability department or the head of the supervisory department of the
respective institution. The current Chair of the ATC is Stefan Ingves, Governor of Sveriges
Riksbank, and the Vice-Chair is Andreas Ittner (Executive Director, Österreichische
Nationalbank).8

To ensure that the ESRB is able to draw on a wide range of expertise, backgrounds and
opinions, the European Parliament led the initiative to set up the ASC. This was achieved in
the first quarter of 2011, following a selection procedure that included a call for expressions
of interest in membership of the Committee, which was posted on the ESRB’s website and
published in the Official Journal of the European Union. The ASC comprises 15 independent
experts, who are appointed for a period of four years. They were chosen on the basis of their
general competence and diverse range of expertise in academic fields or other sectors, in
particular small and medium-sized enterprises or trade unions, or as providers or consumers of
financial services. The ASC also includes the Chair of the ATC. The current Chair of the ASC is
Martin Hellwig and the Vice-Chairs are André Sapir and Marco Pagano.9

Finally, the day-to-day business of the ESRB is carried out by its Secretariat. The ECB ensures
the Secretariat of the ESRB, thereby providing it with analytical, statistical, logistical and
administrative support.10 The support provided by the ECB to the ESRB, as well as the tasks
assigned to the ESRB, are without prejudice to the principle of the independence of the ECB

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8 According to its mandate, the ATC contributes in particular to: i) the regular review of financial stability conditions in the EU,
including the detection of systemic risks; ii) the analytical and policy preparations for discussions within the Steering
Committee and the General Board on warnings and recommendations; iii) the review and possible further development of
macro-prudential policy instruments available to the competent authorities of the EU Member States; iv) the regular
monitoring of the macro-prudential policy decisions taken by the competent authorities both within and outside the EU, as
well as any discussions on their possible implications for the EU as a whole; and v) the execution of other tasks assigned to the
ESRB under EU legislation. In particular, the ATC can assist with the preparation of ESRB opinions on aspects of EU legislation
in the financial field where the legislation expressly requests that the ESRB give recommendations.

9 According to its mandate, the ASC contributes to the fulfilment of the ESRB’s tasks through its analytical and consultative
work. Its analytical work includes improving analytical methodologies for identifying risks and assessing their potential impact,
as well as designing and calibrating effective macro-prudential policy tools by working on existing tools or by proposing new
or complementary ones. Its consultative work includes providing an open, independent and analytical review of macro-
prudential strategies and operational frameworks, in order to ensure that the ESRB’s policy framework is always
state-of-the-art. At the request of the ESRB Chair, the ASC can also suggest topics for, and contribute to, special analytical
studies to be carried out by the ESRB and its member institutions.

10 See Chapter 3.2, entitled, “Tasks concerning the functioning of the European Systemic Risk Board”, Annual Report,
ECB, 2011.
in the performance of its tasks under the Treaty on the Functioning of the European Union. In terms of budget, as part of its support, the ECB dedicated 56 full-time equivalent staff to ESRB activities (of which 25 are employed within the Secretariat). The direct costs amounted to €7.1 million, to which indirect costs relating to other support services shared with the ECB (e.g. human resources, IT and general administration) also have to be added. Overall, the ESRB’s other member institutions allocated at least 14 full-time equivalent staff to ESRB activities in terms of providing input to expert groups and support for those holding chair positions within the ESRB.
Section 2
ESRB activities since its inception in December 2010
In line with its mandate, the activities carried out by the ESRB since its establishment on 16 December 2010 have included: i) identifying and assessing systemic risks, which, in some cases, has led to the adoption of warnings and recommendations; ii) contributing to the establishment of macro-prudential frameworks at the EU and national level; and iii) performing fundamental analysis for macro-prudential oversight and developing analytical tools.

2.1 Identifying and assessing systemic risks

Within the ESRB, there is a regular exchange of views on risks to and vulnerabilities within the EU financial system in order to identify those of systemic relevance. In 2011 the ESRB dealt with general systemic risks related to the fact that the crisis had become systemic, with the potential to affect all EU countries, as well as with more specific systemic risks that, in a number of cases, led to the issuance of warnings or recommendations.

2.1.1 Systemic risks affecting the EU as a whole

The ESRB identified general systemic risks in the EU financial system early on. From the first quarter of 2011 there was a growing number of signs that: i) several EU Member States were at risk of contagion from those Member States under an EU/IMF programme; ii) in the countries affected, the general sovereign risk was making it difficult for banks to fund their borrowing needs; and iii) weakening economic conditions were undermining confidence in the markets.

Throughout 2011 the ESRB closely monitored the growing strains in the EU financial system and publicly highlighted their systemic nature at the hearing of the ESRB Chair before the Committee on Economic and Monetary Affairs of European Parliament on 11 October 2011. On this occasion, the ESRB Chair also made it clear that the crisis was not limited to a few countries and had the potential to affect the EU as a whole, as clearly evidenced by the rapid widening of credit default swap spreads between December 2010 and October 2011 (see Chart 1). The reference to the crisis as systemic was not intended as a declaration of a general state of emergency, but was rather a call for prompt action by all the relevant authorities to each take the measures needed to alleviate concerns.

In late spring 2011 the ESRB also called for the stress-testing exercise conducted by the EBA to be fully credible, asking Member States to provide financial backstops not only for the few banks that had not passed the exercise, but also for those considered by financial markets to be vulnerable or close to the pass/fail threshold. The ESRB stressed that a credible commitment to providing backstops to institutions in financial stress would lead to a lower perception of risks and a reduction in bond yields, thereby supporting growth.

However, the continuous interplay between the above-mentioned risk factors meant that the situation became progressively worse and led international financial markets to start, from late spring 2011, to question the value of financial sector assets. Against this background, banks had to re-examine their business models at a time when their capacity to operate in financial markets was impaired, their dependency on central bank lending was growing, their credit
ratings had suffered severe downgrades and their equity values in stock exchange markets were under pressure (see Chart 2).

In the light of this, in September 2011 the ESRB encouraged the relevant authorities to take all the necessary measures to restore credibility to the financial sector. With regard to sovereign risks, the ESRB called upon the competent authorities to ensure the prompt implementation of the decisions taken by the Heads of State or Government of the euro area and EU institutions on 21 July 2011, which covered, in particular, the strengthening of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), as well as the adoption of sustainable fiscal policies and growth-enhancing structural measures. The ESRB also supported a decision by the EU authorities – upon the initiative of the EBA – to strengthen the capitalisation of the banking sector, which was intended to be one of a package of measures to avoid further financial market disruption.

However, the recapitalisation exercise was not accompanied by other measures necessary to strengthen the banking sector. Credit institutions were called upon to increase their capital levels without complementary action to tackle the sources of the systemic crisis, which were adversely affecting their ability to attract funding. As a result, despite the conditionality and monitoring framework put in place by the EBA, there was a risk that the deleveraging efforts that had already started would be accelerated, triggering a severe contraction in credit supply. For this reason, at the end of 2011 the ESRB called upon all authorities to ensure that the measures necessary for strengthening the capital base of the banking sector did not exacerbate the risk of an economic contraction.
At the end of 2011 the coordinated action of central banks, which included measures to provide liquidity support to credit institutions, helped to allay immediate concerns. At the same time, governments in several EU Member States took resolute action to address fiscal imbalances, and EU leaders and other authorities agreed on several important issues (e.g. the EFSF, the ESM, the fiscal compact, the Greek debt restructuring), which alleviated the most acute problems stemming from the sovereign risk. In the light of these developments, in the first quarter of 2012 the ESRB turned its attention to the risk that improved resilience to sovereign and bank risks would not translate into more lending to the real economy, seen as essential for boosting growth. Therefore, the ESRB called upon governments not to postpone fiscal and structural reforms, and upon banks to take advantage of the improved funding environment to further strengthen their resilience.

2.1.2 Specific systemic risks

In the course of 2011 the ESRB also examined some more specific structural sources of systemic risk, in particular, the risks associated with: i) lending in foreign currencies to unhedged borrowers (i.e. borrowers exposed to a currency mismatch because they do not have a natural or financial hedge); ii) US dollar-denominated funding of credit institutions; and iii) a low interest rate environment.

With regard to the first two sources of systemic risk, the General Board considered the risks sufficiently high to warrant policy recommendations in the form of two public recommendations. These are discussed in more detail in Section 3.

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As part of its work on specific systemic risks, the ESRB also contributed to two public consultations initiated by the ESMA in the context of the upcoming review of the Markets in Financial Instruments Directive (MiFID). One dealt with policy orientations and guidelines for exchange-traded funds (ETFs) subject to undertakings for collective investment in transferable securities (UCITS) and structured UCITS, while the other focused on guidelines for high-frequency trading.

UCITS ETFs and structured UCITS have given cause for concern from a systemic perspective, owing to the dramatic growth in the markets for these instruments over the past ten years and the disproportionately large size of some of them compared with the market capitalisation of the underlying reference indices. The ESRB’s response to the ESMA’s consultation focused on the need to ensure that the guidelines take into account past experience with financial innovation. Given the opacity and complexity of some structured UCITS products, the ESRB suggested looking into the possibility of withdrawing the UCITS label from such products, as it would help to keep UCITS products simple and to maintain trust in the UCITS label. The ESRB also highlighted issues relating to the liquidity provision and price formation processes of ETFs on secondary markets, as well as the risk of regulatory arbitrage between financial products. Lastly, it suggested improving disclosure and introducing stricter guidelines for collateral management.12

In its response to the public consultation on high-frequency trading, which uses strategies that generate profit from potentially small and/or short-lived price discrepancies, the ESRB acknowledged that financial innovation and technological advances have contributed to the ability of financial markets to provide adequate financial services to the real economy. However, at the same time, it recalled that experience has shown that unregulated financial innovation can sometimes pose a systemic risk to the stability of the financial system. Significant technological changes therefore need to be fully understood and monitored carefully. According to the ESRB, this calls for further investigation of two issues of potential systemic relevance: i) the possible detrimental impact of high-frequency trading on market liquidity and integrity; and ii) the potential for high-frequency trading to amplify market shocks. The ESRB also suggested measures for promoting the monitoring and surveillance of algorithmic and high-frequency trading, as well as measures of a more “proactive” nature that merit further study, e.g. crisis management tools and structural measures.13

Concerning the insurance and occupational pension funds industry, the ESRB did not initiate any sector-specific work, but closely monitored developments with assistance from the EIOPA and the national supervisory authorities.

The interplay between sovereign and bank risks, combined with the weakening of the real economy, had a growing impact on the insurance sector and occupational pension funds in 2011. Insurance companies’ income has dwindled over the past few years, particularly as asset prices have also declined. Looking ahead, as a result of the Solvency II Directive14, insurance companies will be exposed to important regulatory changes that might affect their business models, in particular their risk management and investment strategies. However, there is no

12 See the ESRB’s website at www.esrb.europa.eu
13 ibid.
consensus on the nature and magnitude of the impact that this new directive will have, which is a potential source of instability.

Although, owing to their structure, insurance companies and occupational pension funds are less prone to triggering immediate systemic events than the banking sector, they are not immune to the systemic nature of vulnerabilities within the financial sector. Moreover, their growing exposure to the interplay between sovereign and bank risks is becoming a challenge, at least in terms of risk concentration. The current low interest rate environment may also cause difficulties for those insurance companies and occupational pension funds that are contractually obliged to offer a minimum return rate to policyholders and (prospective) pensioners. If the current interest rate conditions deteriorate or remain in place for several years, fragilities in the industry may come to light.

Insurance companies and occupational pension funds are a traditional source of funding for the banking industry, with firms often investing in and/or underwriting banks’ securities. At the moment banks are repaying maturing debt and reducing their interest expenses using low-priced funding obtained through longer-term refinancing operations (LTROs). As a result, long-term investors are currently exposed to reinvestment risk, in conditions where yields are generally low and volatility high. To what extent and how quickly insurers change their investment patterns will influence whether or not financial market conditions will stabilise and have an impact on the overall credit supply.

2.1.3 EU-wide stress-testing exercises

Another aspect of the identification and assessment of systemic risks across the financial sector is that the regulations establishing the ESAs\textsuperscript{15} and the ESRB Regulation require the ESAs, in cooperation with the ESRB, to initiate and coordinate regular EU-wide assessments of the resilience of financial institutions, markets and infrastructures to adverse market developments, i.e. EU-wide stress tests. Accordingly, the ESRB, as macro-prudential overseer, is called upon to contribute to such assessments from a system-wide perspective. The involvement of the ESRB in the technical features of the 2011 EU-wide stress-testing exercises was limited, as they were being developed well before the ESRB was formally established. Nevertheless, the EBA and EIOPA 2011 exercises and their results were discussed in general terms at the meetings of the General Board.

With regard to future EU-wide stress-testing exercises coordinated by the ESAs, work is under way to structure the involvement of the ESRB. Its input should include: i) providing the ESAs with opinions on the most relevant systemic risks and the adverse scenarios prepared for the stress tests; ii) contributing to the peer review and quality assurance exercises; and iii) providing system-wide perspectives on the adverse scenarios tested and on the sensitivity and robustness of the results.

2.2 Contributing to the establishment of macro-prudential frameworks at the EU and national level

In accordance with its mandate, and taking into account that macro-prudential oversight is a new concept, especially in the EU, a large part of the ESRB’s activities in 2011 involved discussing how best to prepare the frameworks for delivering sound macro-prudential policies within the EU over the next few years.

2.2.1 Establishing close links with the three ESAs

At the EU level, as part of the establishment of working relations with the relevant EU institutions, the modalities for cooperating with the three ESAs, i.e. the second pillar of the ESFS, constituted a key work stream. The regulations establishing the ESAs and the ESRB Regulation provide for a broad involvement of the ESAs in all work of the ESRB, in particular policy discussions on warnings and recommendations, their preparation and their follow-up. This includes the development and implementation of analytical tools to aid the identification and assessment of systemic risks. Work conducted in collaboration with the ESAs helped to identify and formalise the mechanisms through which the ESAs can bring their pan-EU micro-prudential perspectives into ESRB policy discussions and actions, and, more generally, procedures for coordinating the objectives, policies and communications of macro-prudential and micro-prudential authorities within the EU.

2.2.2 Work on macro-prudential mandates and tools

Another important area of interest for the ESRB is the development of a basis for sound pre-emptive macro-prudential policies in the EU.

Taking the EU and national dimensions of the ESFS together, the ESRB worked in 2011 on the identification and discussion of some common elements in the macro-prudential mandates and tools, and in particular on steps that national legislative bodies and authorities could take over the next few years.

With the ESRB acting mainly through policy tools that are not legally binding (warnings and recommendations), the effectiveness of macro-prudential policies in the EU very much depends on the macro-prudential policy frameworks of its Member States. Well-defined national macro-prudential mandates are the key to effective EU-wide macro-prudential policies, with macro-prudential authorities acting either on their own initiative or following up on warnings and recommendations from the ESRB. Against this background, the ESRB developed a set of “guiding principles” for such mandates, which led to the adoption of Recommendation ESRB/2011/3 of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities. This is discussed in more detail in Section 3.

This recommendation refers explicitly to the need to grant national macro-prudential authorities control over the tools they require to achieve their objectives. In this respect, the ESRB carried out work – through the Instruments Working Group of the ATC – with a view to establishing a set of macro-prudential tools to be made available for macro-prudential policies throughout the EU. This set of tools will be adapted over time and new tools will be added, as the nature of financial and economic systems inevitably evolves. While some aspects of the set of tools have yet to be defined (e.g. how large it should be), it is clear that a macro-prudential toolkit needs to be sufficiently comprehensive to be able to respond to the full range of systemic risks emanating from the economic and financial cycles, as well as from the structural changes in the financial system. Another important aspect of these tools is that they should be able to be used...
pre-emptively and in a timely manner in order to address the complex and ever-changing nature of systemic risks.

One of the starting points of the selection process for the set of macro-prudential tools was the ESRB Regulation, which tasks the ESRB with contributing to the prevention and mitigation of systemic risks to financial stability, in order to ward off periods of widespread financial distress and ensure a sustainable contribution to economic growth from the financial sector. In this context, a set of intermediate macro-prudential objectives were identified and formed the basis for the selection of macro-prudential tools. In early 2012 the focus shifted to analytical and policy work in a number of areas including: i) the development of instruments; ii) their effectiveness and efficiency; and iii) legal aspects related to their implementation. It is expected that this work will be concluded in early 2013.

2.2.3 Review of macro-prudential aspects of forthcoming EU legislation

As part of the development of a basis for macro-prudential policies in the EU, the ESRB reviewed the macro-prudential aspects and implications of forthcoming EU legislation. In particular, it closely followed discussions on three key pieces of draft EU sectoral legislation, which will have major implications, in terms of scope of intervention, for macro-prudential oversight in the period ahead: i) a draft directive and regulation on capital requirements for credit institutions (hereinafter referred to as the “CRD/CRR”); ii) the proposal for a regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (hereinafter referred to as “EMIR”); and iii) the proposal for the Omnibus II Directive, in which the ESRB paid particular attention to the provisions addressing elements of pro-cyclicality within the Solvency II Directive (e.g. the “counter-cyclical premium”).

With regard to the CRD/CRR, the ESRB communicated a number of policy messages to the EU’s legislative bodies, including the importance of ensuring that the competent national authorities have adequate scope and flexibility to deal with systemic risks, both pre-emptively and in response to the materialisation of such risks.

The proposals for the CRD/CRR incorporate the concepts of maximum harmonisation and a single rulebook, i.e. keeping to a minimum the scope for national flexibility or additional layers of local rules, with a view to avoiding regulatory arbitrage and distortions to competition. The ESRB regards the establishment of a single rulebook based on commonly defined prudential requirements across the EU as essential from a macro-prudential perspective. However, it has also said, on a number of occasions, that, even in a single market with a single rulebook, the national authorities should still be able to tighten the settings of prudential instruments to levels above the minima provided for in EU legislation, in order to address specific risks identified at the national level, taking into account local economic conditions and the fact that economic and financial cycles are not fully harmonised across the EU Member States. Furthermore, they should be able to do so in a timely fashion.


Although taking such action may entail initial costs for the Member State, it would be in the interests of financial stability, as it would help to prevent the development and spreading of crises across the EU. At the same time, the ESRB acknowledged that the use of such discretion for macro-prudential purposes, which should only allow the tightening of settings above the requirements in the CRD/CRR and not the altering of any definitions, must be underpinned by workable safeguards against its potential misuse to pursue anti-competitive goals or protectionist policies and, more generally, against possible adverse spillover effects across borders. Furthermore, such safeguards should not be overly bureaucratic and result in a bias against beneficial action. In this respect, the ESRB could play a key role in ensuring appropriate coordination among national authorities. This issue was raised in a letter from the ESRB Chair to the competent EU institutions on 29 March 2012.18

Another aspect of the CRD/CRR that is of direct relevance to the ESRB relates to the introduction of the counter-cyclical capital buffer under the Basel III agreement. The objective of this new instrument is to allow macro-prudential policy-makers to build up resilience in the financial system, so that it is more able to cope with systemic risks resulting from aggregate credit developments. Building up resilience during economic upswings would better place the financial system to absorb adverse shocks and, in such circumstances, continue providing services to the real economy. The proposals included assigning the ESRB the task of ensuring a consistent EU-wide implementation of the policy frameworks for the buffer by issuing recommendations, guidance and policy principles to be followed by national authorities when exercising their national discretion. While welcoming the buffer as an important contribution to the macro-prudential toolkit in the EU, the General Board made suggestions as to how the effectiveness of the instrument could be improved, focusing in particular on the reference to exceptional circumstances in the setting of buffers in excess of 2.5%, third-country exposures and the scope for international reciprocity. With regard to the principle of reciprocity, which is a cornerstone of the single European market, there was a consensus within the ESRB that prohibiting its application above the 2.5% limit would create opportunities for arbitrage and thus undermine its efforts to safeguard the financial system. The ESRB will also start to prepare guidance on the use of the counter-cyclical capital buffer, as part of the role assigned to it in the draft legislation.

The ESRB also carefully considered the proposals for EMIR, which lays down conditions for increasing the transparency of over-the-counter (OTC) derivatives. All standardised OTC derivative contracts are to be cleared through central counterparties (CCPs) by the end of 2012 at the latest and reported to trade repositories. The ESRB focused its work on the key role to be played by CCPs, making suggestions to the EU’s legislative bodies regarding the requirements for margins and haircuts on collateral for financial products cleared through them. Given that variations in such requirements have the potential to intensify pro-cyclical dynamics and increase leverage within the financial system, the ESRB, in line with proposals discussed in international institutions (including the IMF), suggested that there was a role for macro-prudential overseers in varying minimum requirements for margins and haircuts. Policies could be introduced that seek to limit variations in such requirements, for example by recommending a counter-cyclical approach to setting requirements, i.e. restricting the easing of the requirements during economic upswings in order to limit the tightening that takes place during downturns.

18 See the annex.
2.3 Performing fundamental analysis for macro-prudential oversight and developing analytical tools

Closing knowledge gaps of relevance to the assessment of systemic risks, as well as identifying analytical tools, was another important activity of the ESRB in 2011. It was carried out by the ASC and the Analysis Working Group (AWG) of the ATC.

The work of the ASC, which met for the first time in June 2011 (following the selection of its members), focused on: i) conceptual issues relating to systemic risk and macro-prudential surveillance; ii) quantitative analysis issues and data requirements for the assessment of systemic risks; and iii) the interplay between the financial sector and the real economy.

More specifically, the ASC started to discuss two projects: i) the need for liquid assets and how to deal with this need in the financial system; and ii) systemic risks and macro-prudential concerns. It was decided that the first project would start with an assessment of the advantages and disadvantages of the “European Safe Bonds”, as well as of the role of liquidity provided by central banks. Another important issue for discussion within the framework of this project would be bank solvency and its implications for obtaining funding. The second project would look into the ideal design for a macro-prudential framework that takes into account the three levels of policy decision-making within the EU (national, euro area and EU).

The AWG worked primarily on three main issues in 2011: i) the shadow banking sector in the EU; ii) the interconnectedness and emergence of new systemic players; and iii) the ESRB Risk Dashboard. The common aim of all this work has been to fill knowledge gaps on issues that have the potential to contribute to the build-up of systemic risks and thus create a basis for developing better tools for monitoring and identifying risks.

The shadow banking sector is a broad and complex topic. The work on this issue has been conducted in stages, focusing separately on each potential channel of contagion between the shadow banking sector and the rest of the financial system. In addition, a general data collection exercise was conducted in autumn 2011 as a first step towards mapping and gauging the size and importance of the shadow banking sector in the EU. This exercise is to be completed in 2012, and possibly repeated at a later date as part of the general monitoring of the interaction between the shadow banking sector and the rest of the EU financial system.

Furthermore, the AWG conducted an initial analysis of money market funds from an EU-wide systemic risk perspective in the second half of 2011. From a global perspective, the systemic risks and possible need for policy reforms are currently being analysed by the International Organisation of Securities Commissions (IOSCO), at the request of the Financial Stability Board (FSB). The ESRB intends to conduct further analysis, using the work conducted by the AWG as a basis for assessing, from an EU perspective, the FSB’s recommendations, which are expected to be announced in the summer of 2012.

Other aspects of the AWG’s work on the shadow banking sector focused on gauging potential systemic risks associated with securities financing transactions in the EU, on how knowledge gaps regarding such transactions need to be closed and on what policy action could be taken to mitigate the risks identified. This work is to be finalised in 2012.

As for the interconnectedness and emergence of new systemic players, the AWG initially concentrated on how to use “dynamic network analysis” as a tool for analysing
interconnectedness from an ESRB perspective. Having identified the most relevant topics falling within the remit of the AWG, as well as the data needs associated with those issues, the work was reduced to focus on interbank exposures and CCPs. This fundamental analysis will concentrate on addressing knowledge gaps, as well as identifying potential systemic risks, contagion channels and the possible effects of disturbances on the financial system. Data requests launched in the first part of 2012 are expected to provide input for: i) a detailed mapping of the EU interbank network and an aggregate mapping of exposures (domestic banks, relevant countries and sectors); and ii) an overall mapping of interconnections passing through CCPs, as well as a possible simulation of contagion effects.

The AWG’s analytical work in 2011 also included developing the ESRB Risk Dashboard. According to the ESRB Regulation, the ESRB is required, in collaboration with the ESAs, to develop a common set of quantitative and qualitative indicators (risk dashboard) to identify and measure systemic risk (see Article 3(2)(g)). Like the ESAs, the ESRB is to have its own dashboard. During the second half of 2011 the AWG worked on developing the indicators, both in terms of choosing the right type of indicator and structuring the dashboard in an efficient way. This work also included an assessment of the quality of each indicator chosen, partly through back-testing. The ESRB Risk Dashboard should become operational in the course of 2012.

Finally, through the AWG, the ESRB also provided support for the collection and compilation of consolidated banking data, which used to be carried out by the Banking Supervision Committee of the ESCB.
Section 3
Focus on topical systemic issues
Focus on topical systemic issues

In order to enhance public understanding of macro-prudential oversight, as well as explain the reasons behind the ESRB’s actions (also taking into account that the ESRB cannot discuss confidential warnings and recommendations in its Annual Report), this Section reports on a number of issues addressed by the ESRB in 2011, namely: i) the macro-prudential mandate of national authorities; ii) lending in foreign currencies; iii) US dollar-denominated funding; and iv) the “retailisation” of complex financial products.

3.1 The macro-prudential mandate of national authorities

A well-defined policy framework is key to effective macro-prudential policies. With the establishment of the ESRB within the ESFS, a policy framework was put in place for macro-prudential policies at the EU level, which would be exercised through the issuance of warnings and recommendations. To ensure that the latter are followed up at the national level, the ESRB relies very much on the national macro-prudential policy mandates of the EU Member States, since, in the first instance, it is the responsibility of the national authorities to adopt the measures necessary to ensure the stability of the financial system.

Work on policy mandates for the competent national authorities was initiated in March 2011 by the Instruments Working Group of the ATC. This initially resulted in the development of a set of “guiding principles” for such mandates and, subsequently, in December 2011 in the adoption by the General Board of a public recommendation to Member States in order to provide impetus for the development of sound national macro-prudential policy frameworks, at a time when some legislative initiatives in this regard were being discussed.19

The guiding principles on core elements of national macro-prudential mandates were designed taking into account the need for both consistency among national approaches and flexibility to accommodate national specificities. They cover aspects such as the objective of macro-prudential policy, institutional arrangements, tasks, powers and instruments, transparency and accountability, and the independence of the macro-prudential authority.

The ESRB recommends setting out a clear, explicit objective, as this would help the national macro-prudential authorities to overcome the bias towards inaction. Macro-prudential policies can be pursued at the national level, either upon the initiative of the national macro-prudential authorities, or as a follow-up to recommendations or warnings from the ESRB.

The ESRB considers it important for national legislation to clearly identify the authority responsible for macro-prudential policy. It can generally be either a single institution or a board composed of several institutions that are involved in ensuring the stability of the financial system. The NCBs are expected to play a leading role in this respect, but any action should not jeopardise their independence. The ESRB will discuss potential cross-border spillovers from

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macro-prudential measures planned by the competent national authorities, in order to ensure a minimum degree of coordination and limit the possibility of negative spillover effects. To this end, the ESRB should be informed of macro-prudential actions taken to address systemic risks at the national level.

Member States should ensure that the tasks and powers of the macro-prudential authority are clearly defined. They must also ensure that it has the power to obtain in a timely fashion all relevant data, as well as control over appropriate instruments, so that it can make timely adjustments in response to the changing nature of risks to financial stability.

Finally, the macro-prudential authority should be independent and accountable to its national parliament. Its independence should shield it from external pressure, for instance, not to tighten policies during an economic upswing or loosen them during a downturn.

Member States are requested to implement these recommendations before 1 July 2013 and provide the ESRB with an interim report on their intentions with regard to their implementation, and on the decisions taken to date, by 30 June 2012.

3.2 Lending in foreign currencies

With regard to the non-financial private sector at the EU level, lending in foreign currencies other than the legal tender of the relevant country (hereinafter referred to as “foreign currency lending”) has been most prevalent in the central and eastern European countries (see Chart 3). In some cases, this has led to a build-up of substantial currency mismatches on non-financial private sector balance sheets, which could create systemic risks at the national level with the potential to spread across borders. This, and the fact that measures taken at the national level have been circumvented to various degrees, has given rise to the need for coordinated EU-wide action. To this end, a special ATC expert group was set up at the beginning of 2011.

Chart 3

Foreign currency lending to households and non-financial corporations in the EU

Sources: ECB and ECB calculations.
Notes: This chart depicts foreign currency lending as a percentage of total outstanding loans. The latest observation is for April 2011.
The work undertaken first confirmed that the reasons for the prevalence of foreign currency lending stem from both demand and supply-side factors, including, inter alia, positive interest rate differentials and, in some cases, access to funding from parent banks. High levels of foreign currency lending may entail systemic risks, which could trigger negative cross-border spillover effects. In some cases, it has contributed to the amplification of credit cycles, potentially affecting asset prices. For foreign currency loans to unhedged borrowers (i.e. borrowers exposed to a currency mismatch), credit risk includes market risk, as instalments increase as a result of exchange rate depreciation (if it is not offset by a favourable change in interest rates). Moreover, the dependence on parent banks for funding and, in some cases, reliance on foreign currency swap markets, constitute an additional layer of liquidity and refinancing risk in times of crisis, with the high level of integration between financial groups creating another channel for cross-border contagion.

Owing to the risk of contagion and the possibility that national measures are circumvented, the ESRB drew up public recommendations for the Member States of the EU, their national supervisory authorities, and the EBA, which were adopted by the General Board in September 2011.

The ESRB’s recommendations cover new foreign currency loans (as opposed to the current stock of loans). To tackle credit risk, the recommendations include: i) increasing borrowers’ awareness of risks embedded in foreign currency lending, by requiring that they are given adequate information on such risks; and ii) ensuring that new foreign currency loans are extended only to borrowers that are creditworthy and capable of withstanding severe shocks to the exchange rate. In this respect, the use of debt-to-income and loan-to-value ratios is encouraged. If foreign currency lending starts to fuel excessive overall credit growth, more stringent or new measures should be considered.

To tackle the mispricing of risks associated with foreign currency lending, authorities should require institutions: i) to incorporate these risks more fully into their internal risk pricing and capital allocation; and ii) to hold adequate capital, under Pillar 2 of the Basel II framework. Furthermore, authorities should closely monitor and, if necessary, consider imposing limits on funding and liquidity risks associated with foreign currency lending, paying particular attention to the concentration of funding sources, currency and maturity mismatches between assets and liabilities, and the resulting reliance on foreign currency swap markets.

The recommendations are to be applied at an individual, sub-consolidated and consolidated level. The addressees of the recommendations are requested to report to the ESRB on the actions they have taken to implement the recommendations, or provide adequate justification in the case of inaction, as a rule by 31 December 2012.

### 3.3 US dollar-denominated funding

The US dollar is a material funding currency for EU credit institutions, accounting for around 15% of their total liabilities (see Chart 4). A special ATC expert group was set up in March 2011 to consider what appeared to be a maturity mismatch in US dollars (almost all of the funding available for use in the EU is wholesale and short-term) and the ongoing evidence of strains in

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US dollar funding markets, following those experienced in 2008, which led to the introduction of central bank swap lines to provide access to US dollars.

This expert group pinpointed the combination of a maturity mismatch and a volatile investor base as a key vulnerability. Furthermore, it considered that heightened tensions in US dollar funding markets from June 2011, with some EU credit institutions announcing plans to deleverage US dollar assets, in part to reduce their reliance on US dollar-denominated funding, would give rise to at least two key direct, and potentially systemic, risks: i) the impact on EU credit institutions’ solvency if the assets were to be sold at fire-sale prices; and ii) the impact on the real economy of a scaling-back of lending in US dollars by EU credit institutions.

The expert group also identified structural reasons why the authorities may be concerned about a material maturity mismatch in US dollars in the long term. In addition to the fact that foreign investors tend to retrench more than domestic investors during periods of stress and that time zone frictions increase liquidity risk, the existence of central bank swap lines could be a source of moral hazard risk, as banks delay moving to a more robust funding structure. Indeed, the expert group found that some banks in a number of countries do not plan specifically for funding shocks in US dollars/foreign currencies in their contingency funding plans.

Despite the fact that credit institutions and supervisors introduced measures following the collapse of Lehman Brothers in 2008 in order to mitigate funding and liquidity risks in general, the ESRB considered the issue of EU banks’ reliance on US dollar funding sufficiently important from a systemic point of view to warrant the issuance of policy recommendations. The aim of the recommendations was to avoid that tensions in US dollar funding markets in future financial crises reach the levels experienced during the crises of 2008 and 2011, rather than to mitigate the current tensions.

**Chart 4**

*Gross and net funding positions of EU credit institutions (USD billions; quarterly data)*

![Chart showing gross and net funding positions of EU credit institutions from 1999 to 2011.](source: BIS estimates)
The public recommendation adopted by the ESRB in December 2011 was addressed to the national supervisory authorities of the EU Member States. It recommended that they finalise processes for monitoring banks’ funding and liquidity risks in US dollars, consider limiting those risks before they reach an excessive level and ensure that credit institutions’ contingency funding plans include management actions for handling a shock in US dollar funding.21

These recommendations should help the national supervisory authorities and the EBA to better identify the accumulation of excessive risks in terms of US dollar funding and take preventive measures in order to tackle potential systemic risks.

### 3.4 Retailisation of complex financial products

Over the last few years “retailisation”, i.e. the marketing of complex financial products, such as structured products and some complex exchange-traded products, to retail investors by financial institutions has emerged as a potential source of macro-prudential concern. In the case of certain products, retail clients, when making an investment decision, are unlikely to have the requisite experience, knowledge or expertise to properly assess the risks that they entail. Such products therefore expose investors to market, credit and counterparty risk, without fully compensating them for those risks. The share of structured products sold without capital protection, which could give rise to substantial losses, is increasing significantly in some countries. A special ATC expert group was established in March 2011 to investigate the impact that this may have in terms of systemic risk.

The expert group attributed the increase in the marketing of complex products to retail investors to factors on both the demand side, e.g. the low level of interest rates and related “search for yield”, and the supply side, e.g. the commercial interest in structuring and promoting such products, as higher fees can be charged. In this respect, some of the products are in direct competition with traditional savings products, such as deposits that offer a constant return.

These developments have raised a number of concerns. First, these products have the potential to spread risks through the household sector, as well as influence the transfer and distribution of systemic risks across sectors. Second, large-scale unexpected low returns/losses across the board may trigger a loss of confidence in the financial system, which could, in turn, affect the real economy.

The expert group identified two channels through which systemic risks could spread, namely the household channel and the banking channel. Through the household channel (leaving aside consumer protection aspects of these market segments, which were not covered by the expert group), there is the potential for a wealth effect on GDP growth. For this to happen, the volume of complex products, in particular those with a high risk profile that is unlikely to be understood by retail investors, would have to be considerable and spread through a wide base of investors. Shocks, for instance, negative returns on the products involved, would also need to be large. The banking channel could have negative feedback effects on the real economy, as a result of reduced lending. This could happen, for example, if credit institutions were to lose retailisation as a source of funding on the back of a negative shock in terms of product returns, or if they

were to suffer a loss in credibility as a result of a large-scale mis-selling of complex products to
retail investors.

The expert group concluded that, with regard to the household channel, the potential systemic
risk did not appear to be immediate, although developments should continue to be monitored,
particularly given the lack of EU-wide data on complex products. As regards the banking
channel, it concluded that further investigation would be needed to properly assess the risk that
retailisation dries up as a source of funding for specific banks. Indeed, financial institutions, and
in particular banks, may use structured products as a relatively cheap funding alternative to the
wholesale bond market. This issue in particular is being examined more closely by a new expert
group on bank funding, which was established at the beginning of 2012.
Annex

Letter of 29 March 2012 from the ESRB Chair to the competent EU institutions, entitled “Principles for the development of a macro-prudential framework in the EU in the context of the capital requirements legislation”
Frankfurt, 29 March 2012

To:

The President and Members of the Economic and Financial Affairs Council (ECOFIN)
The President of the European Commission, Vice-President Rehn and Commissioner Barnier
The President of the European Parliament, the Chair of the Committee on Economic and Monetary Affairs, the Rapporteur and the Shadow Rapporteurs on CRR/CRD

Principles for the development of a macro-prudential framework in the EU in the context of the capital requirements legislation

Dear Sir/Madam,

The EU institutions are working to reform the prudential supervision of banks through the Capital Requirements Regulation and Directive (CRR/CRD). With this letter, the ESRB seeks to convey to you and the broader public some principles regarding these reforms from a macro-prudential angle. It hopes that these principles will assist legislators in further developing the basis for macro-prudential actions within the CRR/CRD and in finalising the reforms.

The CRR/CRD reforms arise from the Basel III Agreement and the report of the de Larosière Group, which recommended a single rule book for the supervision of banks and the establishment of a macro-prudential framework. Also from a macro-prudential perspective, the ESRB regards as essential a single rule book based on common definitions for both prudential methodologies and requirements across the Union, and on the full implementation of Basel III.

In pursuing these reforms, the diversity of our Union and the risks its economic and financial systems may give rise to must hold centre stage. Policies must be commensurate with the scale and evolution of future threats at both EU and Member State level, and biases toward inaction must be avoided. Under a single rule book, this approach to risks requires a framework that permits constrained discretion, with workable safeguards, for macro-prudential authorities at both Member State and Union level to tighten calibrations (while leaving definitions untouched) of commonly-defined prudential requirements. This was advocated also by the de Larosière Group (Recommendation 10) and is consistent with advice to the G20 by the Financial Stability Board, International Monetary Fund and the Bank for International Settlements.

Furthermore, the macro-prudential framework must be designed to tackle systemic risk, which includes risks from a wide range of sources: from within the financial system (given intra-system interconnections and contagion between banks, and between banks and others including non-regulated entities or ‘shadow banks’); from the system to the real economy; and from strong feedback mechanisms between the two.
The ESRB has identified three principles to underpin such a framework: flexibility, scope to act early and effectively, and efficient coordination consistent with a ‘constrained discretion’ approach to macro-prudential policy in the EU and its Member States.

First, authorities will require flexibility in the set of available policy tools to both prevent and mitigate specific risks. Macro-prudential authorities at both Member State and Union level need discretion to require additional disclosures and to tighten temporarily a diverse range of (Pillar I) calibrations: for broad requirements, such as aggregate capital levels, liquidity requirements and limits to large exposures and to leverage; and for more targeted requirements, such as sectoral capital requirements to address specific vulnerabilities (e.g. household, corporate, real estate, intra-financial system) across the different parts of banks’ balance sheets (banking and trading books) in order to limit arbitrage. The ESRB is working to develop macro-prudential tools further and, where they are used also for micro-prudential purposes, on ways to ensure consistency.

Second, macro-prudential policy must have the scope to act early and effectively before the build-up of significant imbalances or unstable interconnections, having regard for unintended consequences. This requires a framework that supports the use of the most effective policy tools, for a given risk, in a pre-emptive, timely and efficient manner. Exposures to the same risk must be treated consistently: where institutions exposed to a risk in one Member State are regulated by other Member States, provision should be made for, at least, the voluntary mutual recognition of policy measures between the States concerned.

Finally, discretion to pursue macro-prudential policies in these ways requires efficient coordination as a safeguard to limit possible negative externalities or unintended effects for the sustainability of the single market in financial services or for the economies of other Member States. However, tightening calibrations imposes short-term costs also on initiating Member States, with positive stability externalities across the Union. That calls for ex-ante exchange of information and coordination, rather than for an authorisation procedure by a European body. Without any prejudice to the role of the Commission under the acquis communautaire, competence for this coordination lies with the ESRB as the Union’s macro-prudential overseer.

The ESRB is working out procedures which would support efficient ex-ante coordination, on the basis of advance notification to the ESRB of proposals for macro-prudential action to tackle risks, and with discussions in parallel with the national approval processes as appropriate. Where the ESRB determines that the risks that led to stricter prudential requirements are not justified or cease to exist, the ESRB would issue a recommendation to the Member State in question to remove or adjust the measure. In case of an inadequate follow-up to that recommendation, the ESRB would recommend to the European Commission that it considers appropriate action.

This letter will be published on the ESRB’s website on Monday 2 April 2012.

Yours sincerely

MARIO DRAGHI
**Abbreviations**

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<th>ASC</th>
<th>Advisory Scientific Committee</th>
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<td>ATC</td>
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